## Opinions

# "Industrial Policies" at a Turning Point


## Hiroshi OHASHI

Faculty Fellow, RIETI
Associate professor, the University of Tokyo

PERSONAL DATA

Professor Ohashi's expertise includes industrial organization, international trade, applied econometrics, and applied microeconomics. He obtained his B.A. in Economics from the University of Tokyo in 1993 and Ph. D. in Economics from Northwestern University in 2000. Prior to his current position, he served as an assistant professor at faculty of commerce and business administration in the University of British Columbia. Major works: "Did U.S. Safeguards Resuscitate Harley-Davidson in the 1980s?" (with T. Kitano), *Journal of International Economics* (2009), and others.


**Governments around the world reacted to the global financial crisis by implementing a variety of measures designed to support industry and business and renewing interest in industrial policies, according to RIETI Faculty Fellow, Hiroshi OHASHI. Prof. Ohashi looks at how Japan's industrial policies were used in the past, why interest in them waned in the 1990s, and how future industrial policies can address the needs of industry and business in the wake of the global financial crisis.**

In the course of the global economic crisis, many countries, including Japan, have introduced massive fiscal stimulus packages to support industries and businesses. The United States implemented business support measures and industrial policies designed to promote a low-carbon society, while Germany and France provided extensive support to industries and businesses through credit guarantees and other programs. The introduction of these measures seems to have revived interest in industrial policies, which has been subdued over the past ten or more years. In what follows, I would like to sort out past arguments on industrial policies from an economics viewpoint and discuss the types of industrial policies that need to be implemented as the crisis is over.

### "Industrial policies" in the past

It was probably in the 1980s that industrial policies attracted a great deal of attention for the first time. In a little more than 20 years following the end of World War II, Japan achieved remarkable economic development unparalleled in the world at that time, and in the years that followed, Japan significantly increased its presence in the world economy through trade and investments. Against this background, the view became widespread that Japan's success was attributable to the government's intervention by means of industrial policies. Curiously, debates on industrial policies went on without clearly defining the term and, some people even said that the lack of a clear definition is the very reason why industrial policies gained extensive support. Hereinafter in this article, an industrial policy is defined as a policy that facilitates a shift in inter- or intra-resource allocations from old to new sectors.

From an economics viewpoint, industrial policies have been discussed as a policy tool for correcting a market failure. There are various possible forms of industry and market situations in which the market mechanism, as assumed in classical mathematical economics, does not work efficiently due to such factors as information asymmetry and externalities. Where there exists a market failure that cannot be addressed by the private sector alone, government intervention in the form of industrial policies and the like is justifiable. Against the backdrop of this theoretical logic, vigorous theoretical research efforts were made both in Japan and abroad to analyze oligopolistic markets with a game theory model, and intense policy debate based on this sort of theory continued for some time.

In the 1990s, however, interest in industrial policies subsided, resulting in significant stagnation in industrial policy research. Of various possible reasons for the waning of interest in industrial policies, the most critical was a major shift in government policies in the U.S., the United Kingdom, and some other countries in Europe, to put greater emphasis on the market mechanism. The neo-classical idea that competition among private-sector entities leads to an increase in social welfare gave a big boost to the promotion of deregulation and privatization. In an ironic turn of events, this trend called neo-liberalism obtained support from empirical findings on industrial policies made on the side of economics. That is, ex-post evaluations of past industrial policies found that the empirical evidence of the effectiveness of those policies was less clear-cut than generally expected.

These quantitative research findings on the effectiveness of industrial policies also gave rise to the question of whether governments are capable of properly addressing a market failure. Just as markets can fail, governments can fail and the social costs resulting from a government failure can be non-negligible. In hindsight, the absence of a compelling counter-argument to the criticism that questioned government discerning ability to identify specific industrial sectors to promote with the support of government policies might have been one contributing factor to the accelerated spread of pessimism about the effectiveness of industrial policies. Given the current quality of empirical research on industrial organization, it is difficult to index the degree of market failure in a highly accurate manner. Thus, the suspicion persists that some industrial sectors might have been selected as subject to government support and promotion for reasons other than a market failure (political intervention, rent seeking by bureaucrats, etc.). As a result, the pessimism about the effectiveness of industrial policies globally prevailed.

## New industrial policies in the post economic crisis

Just around the same time as interest in industrial policies began to fade in Japan and elsewhere in the world, we began hearing news reports about Japanese companies being outstripped by overseas competitors in areas where Japan was the world's leader or so we all believed. In such areas as semiconductors, mobile phones and televisions, Japanese companies used to be perceived as excelling in technologies but today they are being left far behind overseas rivals. Likewise, in the field of environment-related technologies such as light-emitting diodes (LEDs) and storage battery technology, it is becoming increasingly uncertain whether Japan will be able to maintain its lead in the coming years as some countries, including the U.S., are now making nationwide efforts to invest in the development of these technologies.

In contrast to remarkable strides made by global companies—particularly those in emerging economies—with government support, Japan's footsteps in its recovery path seem feeble and paralyzed. What is now needed for the Japanese economy is to facilitate a rapid shift in the allocation of resources from old-fashioned industries to new and innovative industries so as to stimulate the currently stagnated Japanese economy. It is imperative

# Opinions

to bolster demand by improving the metabolism on the supply side of the economy in a way leading to the creation of new goods and services.

In improving the metabolism of the Japanese economy as a whole, it is important to focus on: (1) the creation and nurturing of new industries and businesses and (2) the restoration and revitalization of existing businesses. In the course of the latest economic crisis, it became apparent that these two issues cannot be fully addressed by the market mechanism, leaving significant voids that need to be filled by government policies. Regarding (1), it has been empirically verified that new industries and businesses can serve as a driving force for economic growth and innovation, but it generally takes a long time and long-term efforts before they become full-fledged (Josh Lerner, "Boulevard of Broken Dreams," Princeton University Press 2009). Now that the ability of private-sector venture capital (VC) funds to serve as a funds provider has been called into question, it is indispensable for the Japanese government to implement supplementary measures to increase the number of business start-ups, in which Japan lags behind many comparable countries. The government needs to play a leading role in: (1) creating an environment that facilitates the nurturing of entrepreneurs and new industries, (2) generating demand for VC, and (3) expanding the supply of venture capital. Political attention tends to focus on the third point, namely, how much government money should be made available. However, it has been said that the most important in promoting business start-ups and new industries is to create an amiable environment that facilitates business start-ups. Taking lessons from successful examples, various ideas—including a matching-funds program and a greater use of overseas human resources—have been suggested. As far as I know, however, no systematic analysis has yet to take place and it is hoped that theoretical and quantitative research will be conducted in this field.

In view of the fact that the facilitation of business start-ups and the fostering of new industries are a long-term process, existing policies for corporate rehabilitation and revitalization are viable instruments to produce immediate effects. As mentioned at the outset, the latest economic crisis made us realize the effectiveness of government policies in preventing the occurrence of negative externalities in the form of chain-reaction bankruptcies. At the same time, however, it is also an undeniable fact that the somewhat opaque policymaking process, which resulted in the public bailout of specific companies, has aroused a sense of unfairness. At the very least, it must be ensured that such public assistance will not cause any distortion to competition in the domestic market. And to this end, it is essential to evaluate assistance schemes both ex-ante and ex-post from the viewpoint of competition policy and establish a mechanism to minimize the risk of government failure. It is also hoped that the government will actively promote mergers and acquisitions (M&As) to enable more Japanese companies—including those primarily reliant on domestic demand—to undertake business operations with their eyes on emerging and developing economies, and as a way to prompt companies to improve their operating efficiency and restructure their business portfolios. In this regard, laws and regulations that inhibit the consolidation and integration of industries should be reviewed and changed.

There is no one-size-fits-all prescription to invigorate economic activities. Whether in promoting the start-up of new businesses or facilitating the rehabilitation of existing ones, the government needs to implement sensible policies by paying due consideration to the market environment and the structure of the industry in which specific companies operate. While incorporating the perspective of competition policy to ensure transparency and fairness, how should the government implement support measures in such a way as to take advantage of the discipline of market competition and what approach should be taken in carrying out an ex-post evaluation of such measures? These new viewpoints, which have not been addressed in past industrial policies, are indispensable today. In designing and implementing new industrial policies in the post economic crisis, we have to pursue research to flesh out these viewpoints both theoretically and empirically.