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The Marketcraft Solution for the Japanese Economy

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The Japanese government has engaged in a daunting array of market reforms since the 1990s, from deregulation to labor market, corporate governance, and innovation policy reforms. Yet the Japanese economy remains sluggish, wages are stagnant, and productivity lags. Japanese industry has lost ground in areas of strength, such as electronics, and failed to close the gap in areas of weakness, such as software.

So what went wrong? To make this question more tractable, let's subdivide it into four discrete puzzles: 1) Why hasn't deregulation revived the economy? 2) Why hasn't labor market reform spurred greater productivity? 3) Why hasn't corporate governance reform revived Japanese corporations? And 4) Why hasn't Japan been able to emulate the Silicon Valley model of innovation?

I propose a one-word answer for all four puzzles: marketcraft. By marketcraft, I mean the wide range of laws, regulations, business practices, and social norms that govern modern-day markets. Market systems are not natural phenomena that spontaneously arise, but complex institutions that must be created and sustained by the visible hand of the government. Marketcraft is thus a core function of governments roughly comparable to statecraft. And marketcraft has huge welfare implications. Just consider the greatest economic success story of the past few decades, the information technology revolution, and the greatest failure, the global financial crisis. Both are products of marketcraft.

Japanese leaders have fallen into the same trap as their American counterparts: they have viewed government and market as alternatives rather than complements. So they have interpreted market reform as an exercise in removing barriers to the free market – "deregulation," rather than one of building institutions to sustain dynamic markets – marketcraft. And they have focused too much on the futile task of emulating the U.S. model, a model plagued by its own pathologies.

Regulatory Reform

Takeo Hoshi of Stanford University and Anil Kashyap of the University of Chicago have found that Japanese deregulation from 1995 to 2005 did not correlate with any improvement in total factor productivity. How could that be? The standard economic reasoning cannot resolve this puzzle because it assumes that less regulation would liberate markets and thereby enhance competition, reduce costs, and boost productivity.

But the marketcraft perspective offers an answer. It suggests that the appropriate question is not whether regulation increases or decreases, but whether it achieves its policy goal. So if the goal is to enhance competition, then the government's strategy should be to decrease regulations that impede competition and increase regulations that promote it. And in practice, spurring competition often requires more regulation, not less. In telecommunications, for example, governments have forced incumbent carriers to lease their lines to competitors on favorable terms in order to enable competition. Or in electricity, governments have designed complex auction systems to make the markets work. So from this perspective, it makes perfect sense that deregulation alone would not raise productivity across the board.

Labor Markets

Japanese labor market reforms since the 1990s have aimed primarily at helping companies reduce labor costs to cope with economic stagnation. For example, the government gave employers more flexibility with working hours and liberalized restrictions on the use of agency temps. Japanese companies responded by deploying a wide range of measures to reduce labor costs without resorting to mass layoffs. They reduced new hiring, cut bonuses and overtime, and transferred workers to subsidiaries. And they gradually increased the non-regular share of the workforce.

While many of these adjustments made sense in the short term, they took a toll over the longer term. They undermined employment security, increased economic inequality, slowed wage growth, suppressed consumption, and weakened economic performance overall.

Professor Kyoji Fukao of Hitotsubashi University has found that the productivity gap between regular and non-regular workers actually exceeds the wage gap between the two groups. Some might conclude from this that non-regular workers are just bad workers. But Professor Fukao draws a different conclusion: that Japanese firms should increase the share of regular workers in the workforce to improve productivity. After all, companies will invest more in training regular workers than non-regular workers, and workers will naturally be more motivated to upgrade their skills and to improve their performance if they have permanent employee (*shain*) status.

The government's more recent reforms, including Womenomics and the Work Style Reform, point in a more promising direction. They seek not to raise corporate performance at the expense of workers, but to boost productivity by improving working conditions, narrowing the gap between regular and non-regular status, and diversifying work styles. That's better marketcraft.

Corporate Governance

The Japanese government has engaged in a daunting array of corporate law reforms since the 1990s that have shifted corporate governance incrementally from Japan's traditional stakeholder model toward the U.S.-style shareholder model. Most recently, the government revised corporate law in 2014 to require listed companies to have at least two outside directors or to explain publicly why they do not. It then followed with a Corporate Governance Code in 2015, which stipulated that listed companies should publish their basic management philosophy and their policies on executive appointments, remuneration, and shareholder relations. Nevertheless, these reforms have left companies with considerable leeway, and many companies have responded with greater changes in form than in practice.

Japanese companies are right to be cautious about reforms that emulate the U.S.-style shareholder model. Scholarly research on many of the characteristics of the shareholder model – including stock options, outside directors, share buybacks, mergers and acquisitions, and hostile takeovers – has not found much evidence that these features raise corporate performance. So in essence Japan has been trying to emulate a model that has not proven effective in its home country. Meanwhile, American reformers such as presidential candidate Elizabeth Warren are trying to move the United States in the opposition direction, back toward a stakeholder model closer to that of Japan.

This is not to say that Japanese corporate governance does not need reform, as recent scandals have vividly demonstrated. But Japanese firms would be better off revising their own model than trying to emulate that of the United States. In particular, they should strengthen accounting and auditing functions, and improve procedures for the selection, replacement and training of top managers. And they should diversify their boards of directors, with more women, non-Japanese, and/or individuals with varied backgrounds and expertise.

Innovation

The Japanese government has been deploying policies to emulate the Silicon Valley model of innovation for decades, including seed funding for ventures, industry-university partnerships, regional industrial clusters, legal reforms to facilitate venture capital and venture formation, and public campaigns to foster entrepreneurial spirit. And Japan has had some success in developing a venture capital industry and nurturing venture firms. But Japan still lags far behind the United States in the number of firms that enter and exit the market every year and in the scale of venture capital and venture activity. And Japan certainly has not managed to create a home-grown version of Silicon Valley.

Why not? Well, Silicon Valley is an innovation ecosystem, a unique complex of government policies, universities, business practices, and social norms. So Japan could never replicate this ecosystem by copying individual policies or practices. Japan would be better off crafting its own distinctive innovation ecosystem that builds on Japan’s unique strengths, including a talented bureaucracy, strong government-industry ties, effective mechanisms for coordination across the private sector, and a highly skilled and disciplined workforce.

Marketcraft as a Core Government Function

In sum, marketcraft is not simply a mechanism to make specific markets more efficient, but a core government function that can be applied to a variety of policy goals, from boosting productivity to moderating economic inequality. We should view markets as means and not as ends. We should not settle for a passive stance of “leaving” matters to the market, but rather embrace an active one of constantly striving for better marketcraft.

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