

Economic Reform: View from METI

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Abstract

The most spectacular change in the global economic theater is the Japanese economy. The economy, which was about to dominate the global market a decade ago, now seems to have lost its strength completely with no sign of recovery in sight.

Since the middle of the 1980s, the development of IT and globalization created two fundamental changes, namely the development of a powerful global market, and the evolution of the new process by which value was created. During this time period, the yen appreciated sharply and suddenly. However, these changes were not well recognized because of the bubble economy. While these changes require fundamental change of economic structure, Japan was slow in responding to these changes. In the meantime, international deflationary pressures made this even more difficult, and a demographic change – the inversion of the age pyramid in the structure of the national population – was having an increasingly negative impact on economic activity.

In this paper I focus on the new economic reality Japan faces and the four key issues Japan must address while moving towards economic reform. These issues are: new management in the global competitive market; change in the “value creation” paradigm; the problem of deflation; and the Koizumi cabinet and reform of the decision-making process.

Economic Reform: View from METI

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What happened to the Japanese economy?

The most spectacular change in the global economic theater is the Japanese economy. A decade ago, it was about to dominate the global market. Now it seems to have lost its strength completely with no sign of recovery in sight.

Two fundamental changes have occurred since the middle of the 1980s, when Japan was proud of its economic prosperity.

- The first change was the development of a powerful global market. The development of information technology and successful trade negotiations enabled the instant processing of worldwide demand and supply information. This huge and efficient market found the most suitable place for each resource and made resource allocation through a global market dominant. As a result, competitiveness between companies and economies became more and more dependent upon the ability to take advantage of market power.
- The second change occurred in the process by which value was created. The production technology needed to create so-called “high-tech products” was disseminated globally, and such products became simple commodities. To create value, the focus shifted to knowledge-intensive processes that could develop products that meet the specialized preferences of segmented consumers, and provide them in the most timely and effective way.

Today, the competitiveness of enterprises has become dependent on their ability to respond to these changes. Similarly, the development of countries, through investment, depends more heavily on their ability to create an adaptive national environment.

During this time period, the yen appreciated sharply and suddenly. As a result, Japanese export prices increased and the manufacturing industry lost its competitiveness, despite its strong non-price advantages. In this process, basic service sectors, such as telecommunications, energy, and transportation, were slow to adjust prices and this rigidity contributed to a greater competitive gap.

However, these changes were not well-recognized because of the bubble economy. The government, as well as many Japanese companies, failed to adjust their systems to these emerging environments and became uncompetitive. They continued to follow their previous path. They made dubious investments in real estate whose prices had swollen during the bubble economy. When the bubble collapsed, the country was left with significant non-performing loans. The Japanese government was forced to accelerate structural reform of its economy in a harsh economic environment.

International deflationary pressures made this even more difficult. The disintegration of the Soviet Union released a huge amount of human, material and finance capital into the market. This disrupted the global demand and supply balance and caused price declines in many areas. These deflationary pressures made additional economic structural reforms more difficult.

Adjustments made to a national economic system to create globally-competitive industries, including corporate restructuring and the disposal of non-performing loans, will have a deflationary impact. Even when a central bank lowers interest rates in order to facilitate these policies, the real interest rate remains locked in at a high level. Further, it is difficult for

financial institutions to function as an effective intermediary to allocate financial resources in response to expansionary monetary policy when they are burdened by huge non-performing loans. Inevitably, the government had to rely on financial stimulus to fight deflationary pressure. However, the government was trapped by a “stop and go” policy and the plan was too concentrated on public works. As a result, the government’s policies failed to stimulate private demand, created moral hazards and left a huge financial debt with few lasting economic results.

Concurrently, a demographic change – the inversion of the age pyramid in the structure of the national population – was having an increasingly negative impact on economic activity. The decline of Japan’s productive population made it clear that the systemic assumptions in areas such as pensions, insurance and government finance, which are based on population growth, were no longer valid. The continuing decline of the productive population will result in reduced demand on assets, and add to deflationary pressures.

This short history explains the urgency of solving two problems. One is the loss of Japanese corporate competitiveness and the other is the development of a strategy for sustainable growth in the national demand structure. While the resolution of each problem will create a good environment for the solution of other problems, they are independent problems by nature. As time is running out, it is necessary to tackle both problems at the same time.

New management in the global competitive market

1. Financial Resource

The emergence of a gigantic and powerful global market in the 1980s changed the fundamental manner in which enterprise systems performed. Those systems can be characterized as employing capital and human resources from a competitive market and organizing them so as to

produce value effectively and efficiently. It is the financial market that changed most dramatically. The increase of American treasury bonds created an unregulated interest rate market and it changed the fundamental philosophy of the financial regulatory system – from one which regulated in detail so that no bank could become bankrupt to one which relied on self responsibility and which prevents systemic risk. Through that change a new gigantic service industry was born: considering risks and utilizing financial engineering, which bridged lenders of various conditions and borrowers of diverse expectations.

The availability of such a richly diversified service industry for providing capital has exercised a major influence on the survival and competitiveness of companies that have been exposed to a fierce market environment. In the U.S., financial institutions developed and implemented diverse methods based on risk and profitability so as to make the most appropriate arrangements for both lenders and borrowers. By comparison, during the bubble economy, Japanese financial institutions continued their past lending practices. They continued to write loans based upon traditional real estate collateral. This resulted in non-performing loans when the bubble collapsed and caused a crisis in many companies and financial institutions.

Furthermore, facing that crisis, companies were forced to adjust their balance sheets. This in turn led to the collapse of financial institutions, the contraction of loans and investment activity, and the deterioration of the macroeconomic environment.

Since then, financial regulatory reform has proceeded and the safety net has been strengthened (the recent Resona Bank Case can be seen as proof of success). With regard to non-performing loans, the Financial Revitalization Program makes the combined formula of calculating capital and capital evaluation stricter. Further, as far as the revitalization of indebted companies is concerned, a variety of support functions, such as DIP financing, renewal of

bankruptcy laws, the revision of the Law on the Renewal of Industries, and the establishment of “Industry Revitalization Cooperation”, have been developed. At the same time it became clear that non-performing loans, which are really non-operational investments, are not an extraordinary phenomenon of the bubble period, but a phenomenon that is inevitable in this drastically changing economic environment. Further progress in developing the financial and legal infrastructure to facilitate the shift from asset value-based financing to profitability-based financing seems to be taking off.

Currently, the biggest problem facing the Japanese financial sector is that it does not provide enough risk capital to the national economy. Japanese financial assets flow into postal savings and the banking sector, which in turn go to Japanese national bonds. Thus, the majority of financial assets are consumed by the less productive public sector. In contrast, investment in risk capital – such as stocks and investment funds – is very limited. Also the strong demand in “middle risk and middle return” segments, namely vigorous small and medium size industry, is not satisfied. In the United States, those segments are well financed by banks and non-banks utilizing various risk management techniques. This is a great disadvantage to Japan’s national economy, as it suppresses important growth sectors. Now, the government plans to enact general rules for the establishment of various funds, to revise trust rules and for the private sector to develop risk management techniques.

2. Human Resource Market

The new business environment also brought dynamic changes in the human resource market. The Japanese system was guided by the notion of lifetime employment. However the new environment made this notion obsolete. Faced with dynamic global competition and uncertainty,

companies cannot commit to lifetime employment for a majority of workers. Nor is it wise for workers to simply attach their professional skills to one particular company. In other words, life-employment, which was recognized as an advantage of the Japanese economy in the 80s, has now become a weakness. Along with financial resources, human resources are at the core of enterprises competitiveness. The distribution of appropriate human resources where needed directly affects the very competitiveness of the companies and national economies as a whole. Unfortunately, Japan has been very slow in responding to change in this area.

Japan has just started the reconstruction of her labor policy to encourage mobility. In the current Diet session, several laws were revised so that more diversified types of work arrangements become possible. Job introduction services and labor dispatch services are now open to the private sector. But, changes in the system, policy and practice are not completed and there are still many steps to be taken. Social security arrangement for various types of part-time jobs is one, and tax disincentives for certain types of temporary jobs are another. Pension portability is also an urgent topic to be discussed. The development of a labor market related service industry has a special importance. Differing from the financial market, a labor market requires having training and matching services in order to effectively allocate human resources, which differ individually in character and capacities, to the appropriate place. The quality of this service determines the efficiency of every country's labor market. An effective labor market can only be established when such service reaches a certain level. In Japan, this kind of services sector has just started.

The high unemployment rate among young people is a serious and symbolic problem of Japan's labor market. Employment adjustments tend to take place in the recruitment of freshman. As the recession has lingered, the job shortage has continued and the unemployment

rate for young people has increased. As a result, within the last 10 years, the unemployment rate for people less than 24 years old has increased sharply, reaching almost 10%. Further, the number of people unemployed for more than one year has increased. Statistics demonstrate that being unemployed for more than a year makes it difficult for the unemployed to find stable employment in the future. It means that, along with the inversion of the age pyramid, the productive workforce needed to support Japan's future gets smaller and becomes a critical problem.

This kind of phenomenon is not unique to Japan. It was found in the early eighties in America and in the late eighties in Europe. In America, community colleges, which provide training matched to the regional industrial needs with well-coordinated curriculum, played an important role in solving this problem. In England, the New Deal Program for Employment Policy of Prime Minister Blair created a "one stop center." Young counselors listened to the expectations of individual young unemployed people, and they developed training programs for these individuals, taking into consideration their expectations and the hiring possibilities in enterprises. Through this mechanism, with an incentive system for counseling and matching services, they succeeded in employing 300,000 people in three years. With these successful models in mind, four ministries and agencies are developing cross boundary policies.

3. Real Estate Market

Real estate market reform is another urgent issue. After the collapse of the bubble economy, real estate prices have continued to fall to the level of the early '80s. While some argue that prices have already reached their bottom, it is not clear. As the population is about to decline, residential demand cannot be expected to rebound. The market for office rental space is also

expected to be weak, because of slow business activities and a supply increase due to regulatory reform. Therefore, we cannot be sure whether the current prices have bottomed out or not. Needless to say, real estate prices should reflect profitability. However, the Japanese practice is not exactly so. The posted price of real estate is the product of complex calculations with a lot of assumptions and adjustment. In local markets where real estate demand is really weak, a reduction of even one third off of the posted price does not necessarily attract buyers. In this context, the infrastructure of the Japanese real estate market is underdeveloped because of constant upward pressure on price after World War II. The formation of securities such as REIT helps to provide basic information on transactions, but its use is still rare.

4. Corporate Governance

Another important reform element needed for Japanese enterprises to efficiently produce additional value is improved oversight over the decision-making process of corporate executives. Corporations must reform the pressure and checking system for management decision-making to improve its rationality and appropriateness. In traditional Japanese companies, governance relied upon the main bank system and inside boards of directors supported by longtime employment and a bottom-up decision-making system. However, as these two fundamental elements change, reform of “corporate governance” now has become inevitable. As the Yuki Jirushi, Japan Ham, and TEPCO cases in the last year have shown, nobody believes that the current system is working well. When considering a new framework, one can depend either on the institutional decision-making system within the corporation, or on outside pressure, for example the stock market. Moreover, there are many stakeholders in a company, such as shareholders, permanent employees, creditors, clients and regional society, which can also seek

reform. In order to achieve long-term prosperity for corporations, it is necessary to establish a mechanism where each stakeholder engages in the management of the company while making each of those responsibilities clear. Such a mechanism is expected to produce companies with higher levels of employee morale, the ability to properly select executives and a management team capable of adequately implementing corporate plans.

Change in “Value Creation” Paradigm

In addition to the above changes, Japan also has experienced structural change adjusting itself to the new “value creation” paradigm. This new environment requires exploring the specialized satisfaction of segmented customers. Japan must offer services and products developed so that they fit either the detailed expectations of each consumer in a way that cannot be easily imitated. This kind of practice relies on an infrastructure that differs from the past. For example, computer networks and software are of real basic importance. The price and user-friendliness of computer networks influences the very strength and broadness of the market, and will impact on the competitiveness of a national economy as a whole. It also fundamentally changed productivity through the removal of time and space constraints. Activity levels of research and development have become a source of competitiveness. Invisible intellectual property has become a center of value, and the protection of it is critical to national competitiveness.

The importance of start-up companies differs from the past. In an economy led by a dynamic and global market, it is difficult for even the best company to predict the reaction of markets in advance. The winner in the market can be determined only after actual experiences in the market. Business conditions change suddenly and quickly, and quick decisions are critical.

In such an environment, venture businesses have real strengths. The small venture business is best equipped to adapt quickly to new circumstances. Therefore a support system for the creation of venture enterprises is of vital importance for the competitiveness of a national economy. In this context Japan's low start-up rate for new ventures (one-third of that in the U.S.) is extremely worrisome. Japanese companies that were winners in the manufacturing industry were late in responding to that kind of change and the Japanese government was not careful in developing the infrastructure to respond to such a change.

However, in the last few years, progress has been made in many areas. For example, in the IT sector, "IT Strategy Headquarter" is established, telecommunications tariffs were decreased, the propagation of broadband connections was remarkable, and tax incentives for IT investment were greatly expanded. In terms of research and development as well, the General Committee on Science and Technology was established in the cabinet, and R&D government expenditures focused on four important sectors such as biotechnology, environment related technology, IT and nanotechnology. R&D tax reductions were expanded to comparable level to those in the US. As for the protection of intellectual property, a Cabinet Headquarters was established and the level of protection was enhanced. Starting a company became drastically easier with the abolition of the minimum capital requirement and by tax deductions for angel investors.

The Problem of Deflation

The second fundamental problem to be solved is deflation. Every country faces deflationary pressure. In many countries while the price of manufactured goods went down, the price of

services went up. But in Japan's case the price of services also went down as deregulation and the introduction of competition in services combined to correct excess prices in the service sector. This deflationary pressure was intensified by the lack of appropriate potential domestic demand to fill the gap created by lower prices. In many countries the purchasing power produced by a decline in prices increases demand somewhere, and offsets a deflationary trend. Japan's strategy for stimulating demand was to increase public works. Up until the late 80s, Japan's installation ratio of public infrastructure such as roads was relatively low. After the collapse of the bubble economy, the increase in government spending was concentrated on road construction. As a result, road installations quickly improved. Now, in an increasing number of cases, public works do not yield any improvement in economic activity. Criticism of the moral hazards caused by loose procurement practices in public works has intensified. Public works now account for more than 5% of GDP, a level extremely high by industrialized countries' standards. It is now clear that the extension of this policy only contributes to aggravate the public finance deficit and cannot be expected to nourish an autonomous expansion of private demand.

On the other hand, individual consumption stands at about 55% of GDP, that is a level about 10% lower than in the U.S. and Britain. There are many reasons for such a low level of individual consumption: transfer of assets between generations is slow because of the aging of the population; uncertainty towards the future plays a big role; and the insufficient liquidity of residential asset discourages consumption. It is critical to solve these structural elements that discourage consumption. The inheritance tax structure should be changed. In terms of pensions and public finance, there is a necessity to show positive long-term prospects rapidly and in a credible manner. Otherwise people will continue to save their money to prepare for an uncertain

future. Real estate market reform is also critical. At the same time, a comparison with the individual consumption structure of America highlights some differences that affect the quality of life. For example, America's health, medical or nursing services better meet individual needs, and the housing related demand such as for cars, furniture, and capacity development investment are much higher. These are good candidates for sustainable demand to be stimulated in Japan.

In stimulating private demand, governmental means go beyond public expenditures. Deregulation and tax incentives are also important. In the U.S., tax reductions play a central role in economic stimulus packages. Tax reductions give additional purchasing power to the private sector. There are good reasons to use such policies wisely. Properly used they increase competition and release market forces, which help companies, become more competitive. In that sense, the 2003 tax reform package is epoch-making because it introduced extensive tax reductions while moving towards being revenue neutral in the long term.

At the same time, in terms of macroeconomic policy, it is important to reset fiscal policy. Accumulated central government debt has reached 700 trillion yen, a terribly high level even from an international perspective. However, serious business stagnation could result if we simply cut spending and try to recover the primary balance hastily. It is thus necessary to make government spending efficient and effective. New Public Management is one such systemic device that makes the principles of budget use and the auditing of public expenditures more efficient.

In national budget, debt financing, medical care, local government financing and public work are four big items. Among them, the transfer of public money from the central government to regional levels has increased to 30 trillion yen. This is a combination of several factors. Tax revenue allocation between the central government and local ones does not reflect the size of

spending. The gap is filled by a special subsidy and a general subsidy. These subsidies distort the autonomy of local governments. It is extremely important to craft principles to reform this situation. As has been seen in many other countries, lively regional autonomous bodies are an inevitable necessity towards an active economy. The challenge is to decide revenues and expenditure to fit regional responsibilities while adopting an electoral process for individual bodies. The simultaneous decision on three fronts (tax revenue allocation reform, general subsidy reform, special subsidies reform) is extremely important as a first step in building up a system where the efforts of autonomous bodies are rewarded.

Koizumi Cabinet and decision-making process reform

While what should be done has become clear, it is uncertain whether Japan can take these steps in time. The issues on the table are difficult ones which face strong opposition from the coalition of ministries concerned or key governing party members and effected private sector interests, or which are caught in the middle of a wide difference of views among ministries or groups. These are the cases that the traditional policy making process cannot solve. In these cases, it is indispensable to have strong leadership to overcome such difficulties. But that is not enough. The speed of the change is dependent upon how flexible the underlying policymaking process has become.

Economic reform and reform of the policy making process should go together. The Nakasone government, which for the first time set economic reform as a policy agenda item, produced the famous Maekawa report as a bible for economic reform. However, concrete results, such as privatization of the National Railroad and NTT, came out of “administrative reform”.

Every succeeding cabinet has produced similar reports but such reports without policy making process reforms produced little meaningful change.

The core of the difficulty lies in a vertically segmented decision making process, which delegates power to a consensus of “experts”, a narrow range of private sector groups, concerned ministries and specialized politicians. Japan’s civil law tradition gives little authority to the judicial branch, the parliamentary system tends to generously delegate discretionary authority to the executive branch, and the tradition that the “best and brightest” go into the bureaucracy makes the bureaucracy strong enough to exercise its discretionary authorities to control and maintain this consensus system. The requirement for consensus in cabinet decisions, governing party approval processes and advisory body processes gives every party de facto veto power. Thus there is little room for real leaders, substantive or political, to emerge and function .

Some argue that Koizumi Cabinet is “No Action Talk Only.” Others say that Koizumi is really trying to attack fundamental problems of the system. Only time will tell which of these characterizations is correct. . But, it should be noted that accumulated changes in Japan’s decision-making system have made Koizumi’s aggressive political style possible. This was not possible before.

Recent changes in Japan’s election system have forced candidates to more closely follow the center of public opinion. Politicians can no longer expect to be elected by relying only on the strong support of minority special interests. Several revision of the “Election Funds Law” have shifted power from party faction leaders who formerly allocate faction money to central party leadership. Changes in parliamentary procedural practices and the loosening of requirements for consensus have weakened the influence of opposing party politicians who were formerly a part of the consensus circle.

Revisions to the “Administrative Procedural Law” have limited the scope of executive branch discretion. Passage of the Freedom of Information Law has broke the monopoly on relevant information for legislation or policy formulation by the government and its inner circle. It also made “under the table” deals difficult to accomplish. These actions have weakened the control of the bureaucracy and of the LDP consortium.

Revisions to the “Central Government Structure Law” empower the prime minister to override each ministry’s policies . It also gives every ministry authority to propose policy initiatives even if the issue involved does not directly fall within its responsibility. These changes have loosened control of a vertically divided policy making structure, and brought about a changes in the consensus practices of the Cabinet.

Prime Minister Koizumi is fully utilizing these changes. And he has taken further steps by giving longer terms to cabinet ministers which, relatively, has strengthened the ministers and weakened the bureaucracy and therefore made it easier for the Koizumi administration to implement its policies. Koizumi has also effectively utilized “Cabinet Headquarters” which has increased the role of the cabinet office and reduced the role of each ministry in policy formulation. Koizumi has openly disregarded the consensus principle on important advisory body policy recommendations and he has challenged the established practice which requires governing party approval before Cabinet decisions are made. He has identified and called for reform on issues such as Postal savings, road construction and local government subsidies as symbols of “special interest politics”. These tactics have produced substantial stresses for many LDP Diet members while receiving high approval rating from the public. In the context of the LDP presidential election, faction leaders, powerful politicians and some of his advisors have urged him to change his tactics to secure wider support within the LDP. However, it is said that

Koizumi knows that LDP members in the Diet who expect elections soon cannot oppose him as long as he maintains a high level of public support, and that he has no reason to change his strategy. If this scenario holds true, a series of necessary decisions can be made quickly after the reelection of Prime Minister Koizumi and it may eventually produce economic reform in Japan.

Lastly, let me touch upon METI. METI has been playing a leading role in “Economic Reform.” Many observers were surprised to see that the “notorious MITI” became the strongest proponent of deregulation and competition. METI is a very unique institution. It changed its name three times. It also changed its mission three times.

First, it played a leading role in the reconstruction of the Japanese economy after the WWII. It had legal authority to allocate all materials to business activities. In many cases it intervened in business decision, while it participated in designing legal and institutional frameworks and in planning critical infrastructures for reconstruction.

In the late 1960s and 70s when the Japanese economy reached the stage to reenter the international trading system, Japan had to stop rationing practice and MITI reoriented its mission after a severe internal struggle. MITI found its role in changing the Japanese economy from a tightly controlled economy to a more market based economy. It used subtle signals and soft visions to guide the allocation of critical resources.

In the 1980s, Japan’s economy came under attack as unfair and too aggressive. Japan was pressured to change its economic structure. MITI undertook serious efforts to change the country’s basic economic structure towards one less reliant on government intervention and more reliant on domestic demand-led growth. In the meantime Japanese industries rapidly lost their competitiveness and her economic power weakened. Japan’s unique mixture of markets and

government intervention became obsolete and a handicap. As a result, MITI became even more aggressive in pursuing economic reform.

There are many reasons why METI can play such a unique role. Its wider responsibility over economic activities prevented METI from becoming a prisoner of special interests), the coexistence of responsibility for both domestic economic policy and the international economic system gives METI a wider perspective, good access to high quality information and the ability to analyze and to formulate relevant policies. Close tie with a wide range of vocal business leaders along with wide access to key people contributed to METI's ability to realize its proposals. These capabilities and a free atmosphere allowed METI to attract excellent young recruits.

METI's strengths can be summarized as excellent access to high quality information, rich human resources to process this information and to formulate policy, and good access to central policymaking process figures.

However, these circumstances are changing. Global markets and their competition require far more detailed information and more segmented analytical capability for METI to really follow and contribute to critical business and policy decisions. On the other hand, new laws regulating public servant ethics prevent METI officials from exchanging delicate and important information with private sector individuals. Thus, traditional METI information gathering operations often fail to produce high quality information.

Human resources are another problem for METI. Some METI officials prefer more active involvement in business activities, others like to focus on more detailed academic work and some like to be free from organizational boundaries. The lower social status of bureaucrats discourages young officials from staying in the government. They leave the Ministry, and move

into the private sector, the academic world and the legislative branch. The increasing demand for METI people in newly created cabinet offices has made the situation worse. These developments have lessened the human resources of METI. How to cope with this challenge has become an important management issue.

Thirdly, the diversification of ways in which to affect public policy lessens the value of METI as an important policy realization vehicle for young officials. Now, METI is not the single way for young bureaucrats to have an impact on policy. The cabinet office and political parties welcome policy proposals and sometime provide an easier way of realizing recommendations. Think tanks are also actively producing proposals.

RIETI, which was originally established as an internal research branch of METI to focus on long term subjects, plays an effective role in coping with such developments. In 2001 it became an independent government agency.

Now, it provides an opportunity to acquire high quality information by forming attractive and high quality study groups in which many private sector players like to participate. It also satisfies the intellectual interests of young officials by providing a vehicle to conduct researches and publish what he or she really believes. It further influences policy through interactions with the intellectual community. When political tensions become unbearable in situations such as a change of governing parties, it can provide an opportunity for some high-ranking officials to intellectually continue to contribute to policymaking and helping to maintain a solid basis for continuity of policy.

Closing

Much of what I have described above is Japan's unique version of the fundamental clash between, on one side, the existing societal vested interests allied with spent or declining economic forces that represents and seeks to maintain an idealized version of past economic power and which still retains substantial political, economic and bureaucratic power, and, on the other side, the irresistible forces of change brought about by the rapid and historic worldwide social and economic changes of the last decade. As usual in such cases, these new economic realities have few of the institutionalized powers to call upon to bring about the changes essential for Japan's national interest. That Japan must change and is changing is beyond question. What is in dispute is the time and costs – economic and societal -- that must be endured until the realities of today overcome those vested interests and are able to create the necessary social and economic structures that will once again allow Japan to contribute her full potential domestically and to world markets to the betterment of all mankind.