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A LOOMING ENTRY BARRIER: JAPAN'S PRODUCTION NETWORKS IN ASIA

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FOREWORD

Historically, a primary goal of America's Asia policy has been the preservation of unimpeded access to the markets of the region. During the Cold War, security concerns took precedence, but economic issues have now returned to the forefront of our Asian policy agenda. In this issue of the *NBR Analysis*, Kozo Yamamura, professor of East Asian studies and economics at the University of Washington, and Walter Hatch, a Fulbright scholar at Keio University in Japan, discuss their newly completed study of Japanese trade, investment, and business practices in Asia and point to a new challenge to market access that will require an innovative and expeditious response from U.S. policymakers.

The authors find that since the mid-1980s Japan has adopted what might be called a regional industrial policy, quite similar to the industrial policy used to develop its internal economy and with the same kind of exclusionary effects that have made the market in Japan so difficult for foreign companies to penetrate. This policy involves close business-government cooperation and the use of private investment and official aid to help Japanese multinationals build vertically integrated production networks throughout Asia. The interfirm relations that proliferated during Japan's high-growth period are now being replicated region-wide. That is, the small and medium-sized firms belonging to vertically integrated *keiretsu* (enterprise groups) at home are following their parent firms abroad. In addition, majority-owned subsidiaries and local Asian firms are being drawn into these networks as junior members.

The authors assert that in automobile, auto parts, electronics, machinery, and other important industries, these Japanese production networks represent an Asia-wide threat to free and open trade because they pressure their suppliers and distributors to do business only with them and shun contacts with firms not belonging to these networks. Japanese multinational enterprises maintain tight control over their network members by developing long-term, multifaceted relationships as the purchaser of the network's manufactures and as the supplier of the network's capital, technology, and managerial guidance. As these networks gain dominant market share, Yamamura and Hatch find ample evidence that American firms are deterred from entry. They also argue that the networks' market power holds a long-term danger for the host economies, which become "captive" to network strategies that strictly control diffusion of technology, impose harsh contract terms, and limit the promotion of local managers.

As Japanese-led networks establish themselves within East Asian markets in this way, Japanese concern over issues of protectionism and trade and investment liberalization in Asian economies is eased. Thus in 1992 the then Japanese ambassador to Thailand wrote in a revealing essay for a Japanese magazine:

When the bulk of [Japan's Asian] trade consists of captive imports from factories built through direct investment and the captive export of machinery and

materials needed to produce such merchandise, there is little need to worry about protectionism. Indeed, current investment patterns are more likely to cause friction with areas outside the region than within it, as Western nations begin to suspect Japan of exporting its system of vertically integrated corporate groups, or *keiretsu*, and shutting other countries out of the market.¹

While some observers may expect overseas Chinese business groups or other Asian multinationals to serve as counterweights to Japanese networks, the authors find them less integrated and less strategically coordinated. Ethnic Chinese business groups have invested most heavily in services and real estate rather than manufacturing. Moreover, these and other Asian business groups are often incorporated into Japanese networks. The authors are skeptical that Chinese entrepreneurial networks will succeed in challenging the Japanese in East Asia's regional economy.

Their study acknowledges that American industry is doing well in many sectors in Asia, such as semiconductors and computers, and waging successful battles in other industries. They also point out that China poses immense challenges for Japanese companies that are compelled to play catch-up with already established Western firms. Nonetheless, the implication of this study is that, despite the prolonged and painful recession and banking crisis that Japan is experiencing, American policymakers must avoid complacency and seriously address the issues raised.

Yamamura and Hatch believe that only the United States has the political capacity to effectively counter Japan's emerging and deepening production alliances in Asia. They recommend that the United States work through the World Trade Organization and the Asia-Pacific Economic Cooperation forum to collect data, to inquire into the long-term costs of undue market power acquired by these networks, and to create an antitrust mechanism. If the United States does not move expeditiously, they conclude, these networks will become increasingly embedded in many Asian economies.

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President
The National Bureau of Asian Research

¹ See Kenneth B. Pyle, *The Japanese Question: Power and Purpose in a New Era*, Washington, DC: The American Enterprise Institute, Second Edition, 1996, pp. 163-164.

A LOOMING ENTRY BARRIER: JAPAN'S PRODUCTION NETWORKS IN ASIA

Kozo Yamamura and Walter Hatch

In 1991, before Japan's economy began to sputter badly, several American reporters marked the 50th anniversary of Pearl Harbor Day by describing what they viewed as Japanese efforts to create "a new co-prosperity sphere" in Asia—this time by commercial, not military, means.¹ They painted a stark, even frightening picture of a potentially autarkic bloc.

Today, as Japan struggles to pull itself out of its serious post-"bubble" recession, agitated "Japan bashing" has yielded to lackadaisical "Japan passing." Opinion leaders in the West are obsessed with China and the overseas Chinese, and seem increasingly disinterested in Japan's investment in and aid to Asian nations.² Meanwhile, neoclassical analysis—holding that disparate economic systems will converge; capital and technology will move in search of the highest possible returns for the benefit of both foreign multinational firms and host economies; and large trade imbalances will disappear sooner rather than later—suddenly seems to enjoy renewed popular credibility.

Yet the current U.S. policy toward Asia, guided by a sanguine, neoclassical analysis of Japanese business activity in the region, is no less misguided than yesterday's journalistic hysteria. The basis for this argument is our view that the Japanese government and multinational firms are not promoting an inward-looking trading regime in Asia but are in fact building a high-technology production alliance that tends to be exclusionary. In other words, they are regionalizing the web of political and industrial ties that have made Japan itself so difficult to penetrate. Unless this trend is recognized and strategic initiatives to counter it are undertaken, "outsiders" (including U.S. multinationals) could find themselves increasingly and seriously disadvantaged in their efforts to compete with Japanese "insiders" in this, the most economically dynamic region of the world. In addition, the stability of the global trading regime would be seriously threatened by the trade effects of Japan's production networks in Asia.

An inevitable result of such trade effects will be persistent and increasing trade conflict in the very near future between Japan and its trading partners. The conflict will be extremely difficult to solve because it will arise not from ongoing trade practices but from the economic realities that have become embedded because of Japan's policy toward Asia and the behavior of Japanese firms in Asia.

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¹ See, for example, David Sanger, "Power of the Yen Winning Asia," *The New York Times*, December 5, 1991, p. C1.

² In this article, when we speak of "Asia," we are generally referring to the four newly industrializing economies (South Korea, Taiwan, Singapore, and Hong Kong), the ASEAN-4 (the four core members of the Association of Southeast Asian Nations: Thailand, Malaysia, Indonesia, and the Philippines), and China.

In Section I of this article, we describe the dominant view of Japanese economic activity in Asia and outline our own dissenting view. The latter is spelled out more fully in our recent book, *Asia in Japan's Embrace: Building a Regional Production Alliance*.³ In Section II, we summarize the findings of a study we conducted in 1995 and 1996 that sought to update and broaden the book's analysis.⁴ In Section III, we explore the policy implications of our findings.

I. Contrasting Views

Although it has many variations, the dominant view of Asia's recent economic development generally holds that: (1) Asia has outperformed all other regions of the world over the past decade because of the steady growth of increasingly competitive, export-oriented manufacturing industries; (2) this growth has arisen from comparative advantages in low-cost but increasingly well-educated labor, growth of demand in Asia, impressive rates of capital formation, and market-conforming government policies; and (3) developed economies, especially Japan, have contributed to this virtuous cycle of industrial growth by supplying not only capital, but also critically needed production and process technology, which is diffusing rapidly in response to market forces.⁵

In general, scholars subscribing to this view either refuse to recognize any significant differences between Japanese and non-Japanese suppliers of capital and technology, or they predict that any such differences will soon cease to exist.⁶ And while they acknowledge the very large and growing trade deficits that most Asian economies have with Japan, as well as the expanding trade surpluses these economies have with the United States, these scholars expect such imbalances to disappear in the very near future. This has become a familiar view, based essentially on neoclassical economic theory and advanced in an increasingly large number of scholarly works, government publications, industry reports, and the mass media.

... because the tools of most neoclassical economists are "universalistic" (i.e., assume away institutional differences between nations), the distinctive institutions that have shaped and continue to shape the Japanese political economy are ignored in their analyses of Japan's growing economic presence in Asia.

³ Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace: Building a Regional Production Alliance*, Cambridge: Cambridge University Press, 1996.

⁴ The authors gratefully acknowledge the support of the Japan-U.S. Friendship Commission, which made our follow-up research possible.

⁵ This view is found in a large and growing number of works by neoclassical economists. See, for example, Seiji Naya and Eric Ramstetter, "Policy Interactions and Direct Foreign Investment in East and Southeast Asia," *Journal of World Trade*, vol. 22, no. 2 (April 1988); Gary Saxonhouse, "Pricing Strategies and Trading Blocs in East Asia," and Jeffrey A. Frankel, "Is Japan Creating a Yen Bloc in East Asia and the Pacific?" in Jeffrey A. Frankel and Miles Kahler, eds., *Regionalism and Rivalry: Japan and the United States in Pacific Asia*, Chicago: University of Chicago Press, 1993; Shujiro Urata, "Changing Patterns of Direct Investment and Implications for Trade and Investment," in C. Fred Bergsten and Marcus Noland, eds., *Pacific Dynamism and the International Economic System*, Washington, DC: Institute for International Economics, 1993; and World Bank, *The East Asian Economic Miracle: Economic Growth and Public Policy*, New York: Oxford University Press, 1993.

⁶ Dieter Ernst is one of those predicting convergence. See his essay, "Carriers of Regionalization: The East Asian Production Networks of Japanese Electronics Firms," Working Paper 73, Berkeley Roundtable on the International Economy, November 1994. Also see Shigeki Tejima, "The Structural Changes of Japanese Manufacturing Companies' Competitive Advantages through FDI toward a More Market-oriented Direction," a paper prepared for the Globalization and Capitalism Diversity Conference, Florence, Italy, 1996.

The central message of this view is that what is taking place in Asia—the heavy inflow of foreign direct investment (FDI), the rapid expansion of increasingly sophisticated industrial production, the emergence of a triangular pattern of trade, and so on—is due principally to the working of market forces, and thus can be readily explained by the theoretical tools of neoclassical economics. However, because the tools of most neoclassical economists are “universalistic” (i.e., assume away institutional differences between nations), the distinctive institutions that have shaped and continue to shape the Japanese political economy are ignored in their analyses of Japan’s growing economic presence in Asia. In addition, because those tools, best suited for static equilibrium analysis, have not yet incorporated the more dynamic variable of technological change, they are unable to analyze adequately the dynamic process of economic growth.

In contrast, our analysis, influenced heavily by the theory of “new industrial organization”—the theory of organization, behavior, and governance of firms that focuses on transaction costs—and by the seminal “anticlassical” analysis of Yasusuke Murakami, attempts to correct the above-noted failings of neoclassical analysis.⁷ We begin by noting that Japan used a specific set of policies and practices to achieve rapid economic growth in the 1950s and 1960s, when its economy was still developing (i.e., still drawing from the global reservoir of existing technology). These policies and practices, which Murakami has called “developmentalist,” enabled large manufacturing firms to reduce steadily their production costs over time by adopting successively more sophisticated technology.

For example, the Japanese government encouraged saving and allocated as much capital as possible at the lowest possible cost to innovating industries. In addition, the government authorized numerous temporary cartels to coordinate the pace of investment in increasingly technologically advanced industries, thereby avoiding the chaos of excessive competition in the short run and the risk of monopolistic market structure in the long run. With direct and indirect aid from the government, manufacturers also organized themselves into horizontal and vertical *keiretsu*, or enterprise groups, to reduce transaction costs (the costs of finding customers and negotiating, monitoring, and enforcing contracts) by cooperating on the use of capital, technology, and personnel. For much of the postwar period, these groups served as built-in insurance houses, fostering market-share-maximizing strategies by distributing otherwise unacceptable risks among members.⁸

As Murakami argues, developmentalism can yield significant benefits for an industrializing country. However, it can also generate enormous costs for an industrialized country that already has fully absorbed the global pool of existing technology. These costs may include an entrenched and protective bureaucratic-industrial elite, exceptionally high domestic prices, labor-market rigidities, and friction with trading partners.

Japan, we argue, perfectly fits Murakami’s description of an industrialized country paying the price for what we must call “post-industrial developmentalism.” The government-business alliance that runs the country thus faces a choice. It can dismantle its developmentalist system, pursuing deregulation, enforcing its underutilized Antimonopoly Act (promulgated in 1947 and

⁷ A good introduction to the theory of new industrial organization is Oliver E. Williamson and Sidney G. Winter, eds., *The Nature of the Firm*, Oxford: Oxford University Press, 1993. For further discussion and the literature, see Walter Hatch and Kozo Yamamura, *Asia in Japan’s Embrace*, *op. cit.*, pp. 46–49. In the context of this study, also useful in offering analytic discussions of firm behavior and its roles in economic growth is Douglass North, *Institutions, Institutional Change, and Economic Performance*, Cambridge: Cambridge University Press, 1990. The work by Murakami referred to is *An Anticlassical Political-Economic Analysis: A Vision for the Next Century*, Stanford: Stanford University Press, 1996.

⁸ Among the many works discussing the economic efficiency of *keiretsu*, the most useful are Iwao Nakatani, “The Economic Role of Financial Corporate Groupings,” in Masahiko Aoki, ed., *The Economic Analysis of the Firm*, Amsterdam: North-Holland, 1984; Masahiko Aoki, *Information, Incentives and Bargaining in the Japanese Economy*, Cambridge: Cambridge University Press, 1988; and Kenichi Imai and Ryutaro Komiya, eds., *Business Enterprise in Japan: Views of Leading Japanese Economists*, Cambridge, MA: The MIT Press, 1994.

substantially weakened in 1949 and 1953), and taking other measures to smooth out the distortions created when a developed economy continues to pursue developmentalism; or it can try to export this system to new, more fertile, and still developing ground.

Japan is pursuing the latter course, we argue, because government and business elites are persuaded that doing so is in their best interests. For the economic ministries, an initiative to regionalize Japan's developmentalism offers the promise of expanded jurisdiction and authority after two decades of internecine struggles over declining turf. For the large manufacturing firms, such a program allows them to capitalize on the deepening division of labor within Asia and thereby maintain relatively high profits with relatively low risk during an era of economic retrenchment at home.⁹

Japan's government-business alliance, then, is pursuing an Asia-wide version of developmentalism. That is, it is exporting to the region a set of pro-growth government policies and cooperative industry practices designed to help leading manufacturing firms achieve efficiencies and market power by adopting successively more advanced technology.

The evidence in support of this view seems overwhelming. Since the mid-1980s, Japanese multinational enterprises (MNEs) have been building vertically integrated production networks (i.e., parent-subcontractor networks) that they dominate in and across Asian economies. These networks, which have made a decisive contribution to the growth of manufacturing industries in Asia, are replications of or close facsimiles of the *keiretsu* in Japan.¹⁰ Just as they do at home, parent firms (Japanese MNEs and their large manufacturing affiliates in Asia) embrace their subcontractors (small and medium-sized Japanese and Asian firms in Asia) in long-term, intensive, and multifaceted relationships.¹¹

Using these close ties, Japanese parent firms are able to control the pace of technology transfer (and thereby capture the rent on their innovation) more than American or European firms can. For example, they rely on established suppliers, usually Japanese, to move sophisticated auto parts or electronic components to their Asian factories. And compared with their U.S. counterparts, Japanese affiliates in Asia continue to employ a large number of expatriates in management positions. Technology is transferred, but only within the carefully controlled confines of a firm's vertically quasi-integrated network.¹²

In attempting to build these Asia-wide production networks, Japanese manufacturers receive strong support, both direct and indirect, from their own government. Japan provides by far the largest amount of official development assistance (ODA) to Asian economies, as well as many types of financial and administrative assistance (e.g., low-cost loans from government-owned banks and subsidies in various forms), much of which is used to attract or sustain Japanese

⁹ In recent years, Japanese affiliates in Asia have consistently outperformed Japanese affiliates in the rest of the world. In 1993, for example, they earned an estimated \$3.3 billion, while their counterparts in Europe lost \$357 million and those in North America lost \$772 million. Ministry of International Trade and Industry (Japan), *Wagakuni kigyo no kaigai jigyo katsudo, dai ni-juyon kai* (The overseas business activities of Japanese firms, No. 24), Tokyo: Ministry of Finance Printing Bureau, 1995, p. 134.

¹⁰ In her study of Japanese business activities in Asia, Diane Manifold found that *keiretsu* members constituted well over half (61 percent) of the firms moving into Indonesia and about half (48 percent) of those moving into Thailand. See Diane Manifold, "Japanese Corporate Activities in Asia: Implications for U.S.-Japan Relations," in USJP Occasional Paper, 1996, p. 35.

¹¹ The relationships are "multifaceted" because, like *keiretsu* ties in Japan, they usually involve intra-group trade, cross-shareholding, and interlocking directorates. In addition, parent firms usually provide technological guidance and managerial assistance. Useful nontechnical works on *keiretsu* relationships are Michael Gerlach, *Alliance Capitalism: The Social Organization of Japanese Business*, Berkeley: University of California Press, 1992; Michael Gerlach, "Twilight of the *Keiretsu*? A Critical Assessment," *Journal of Japanese Studies*, vol. 18, no. 1 (Winter 1992); and Kenichi Imai and Ikuyo Kaneko, *Nettowaku soshiki ron* (Theory of the network system), Tokyo: Iwanami Shoten, 1988.

¹² See, for example, Takao Kiba and Fumio Kodama, "Measurement and Analysis of the Progress of International Technology Transfer: Case Study of Direct Investment in East Asian Countries by Japanese Companies," NISTEP Report No. 18, National Institute of Science and Technology Policy, Science and Technology Agency of Japan, April 1991.

manufacturing investment in the region. No Western government assists its own firms to the extent that Japan's does.

The foregoing is not to argue that Japan is pursuing a state-led program of "neocolonialism" or geopolitical "hegemonism" in Asia, but rather to argue that Japan's leading industries and bureaucracies are waging a spirited battle to hang onto what they have enjoyed up to now—wealth and power—by collaborating. Such is the "path-dependent" nature of Japanese developmentalism.¹³

While many Asian nations are trying to follow in Japan's developmentalist footsteps by adopting parts of what they view as "the Japanese model," none has managed to do so successfully. Even in places such as South Korea and Taiwan, large manufacturers do not bind themselves to, and thus nurture, smaller suppliers. Nor do government and business elites cultivate cooperative ties with labor. In Southeast Asia, regimes have failed to promote indigenous innovation, relying instead on imported technology from the West and, increasingly, from Japan. Unlike the Japanese state, these regimes operate largely on the basis of patron-client ties—a feature that makes them more than a little accommodating to wealthy foreign benefactors, both governmental and private (MNEs).¹⁴

. . . an increasing number of Asian firms are becoming junior members of vertically integrated production networks and thereby gaining access to Japanese capital, technology, better paying employment opportunities, and increasing opportunities to produce and export manufactured products.

Asian economies are benefiting from the increasing economic presence of Japanese production networks in their midst very much like less industrialized prefectures of Japan did from the expansion of *keiretsu* subcontracting networks throughout Japan during the rapid growth period.¹⁵ That is, an increasing number of Asian firms are becoming junior members of vertically integrated production networks and thereby gaining access to Japanese capital, technology, better paying employment opportunities, and increasing opportunities to produce and export manufactured products. They are enjoying, in other words, the benefits of "embraced development." In time, however, the benefits of "embraced development" may very well become the costs of what we call "captive development."

These costs, which come in two related forms, are analogous to those borne increasingly by Japanese small and medium-sized subcontractors.¹⁶ First, the technological capabilities of subor-

¹³ "Path-dependence" is a syndrome in which an institution's peculiar structure of incentives in the present helps to determine its interests, and thus the behavior of its relevant actors, well into the future. The concept (articulated most cogently, we think, by North, *Institutions, Institutional Change and Economic Performance*, *op. cit.*, pp. 93–98) is now a bit hackneyed among political economists, but is less well-known outside the field.

¹⁴ See Kunio Yoshihara, *The Rise of Ersatz Capitalism in Southeast Asia*, Singapore: Oxford University Press, 1988.

¹⁵ Using a similar analysis, Seiki Mitsuhiro argues that developing economies in Asia are replacing Japan's "industrial or company towns" in otherwise rural prefectures as mass production sites for Tokyo-based parent companies. See Seiki Mitsuhiro, *Furu setto gata sangyo kozo o koete, higashi Ajia shinjidai no naka Nihon sangyo* (Beyond the full-set industrial structure: Japanese industry in the new East Asian era), Tokyo: Chuo Koronsha, 1993.

¹⁶ Economists have argued for years that parent firms in Japan aid their *keiretsu*-affiliated subcontractors by absorbing risks associated with the subcontractors' fluctuating production costs. A recent study by Okamura, however, effectively criticizes the analytic methods to date and presents strong evidence that parent firms shed their own risk from demand fluctuation as much as they absorb risk from suppliers facing cost fluctuation, and that they absorb far less risk today, when there are fewer gains from technology adoption to share, than they did in the past. Hiroyuki Okamura, "Changing Subcontractor Relations and Risk-Sharing in Japan: An Econometric Analysis of the Automobile Industry," *Hitotsubashi Journal of Economics*, vol. 36, no. 2 (December 1995), pp. 207–18.

dinate firms (and thus the types of products and parts they produce) tend to be determined in large part by the long-range needs and strategies of Japanese multinational enterprises. In other words, those capabilities remain only at the level necessary to produce less technologically sophisticated parts and products, while the capabilities of Japanese MNEs remain at the higher level needed to produce the most technologically sophisticated products and parts. Second, when demand for products and parts declines (because of a recession, the end of a “product cycle,” or other reasons), the subordinate firms, especially smaller Asian-owned operations, will be forced to reduce the price of products and parts they supply and/or to reduce their output—sometimes even to the point of bankruptcy. Parent firms can impose these costs of captive development on their subcontractors in Asia because they hold critical “hostages” (capital and human resources used to produce specific products and parts for parent firms) and thus have bargaining power over those subcontractors.¹⁷

. . . more and more markets in Asia are becoming like the many Japanese markets that are extremely difficult to enter.

The *keiretsu*-like production networks built by Japanese multinationals in Asia are able to increase the competitive capabilities of firms in the networks because such networks reduce the costs of transaction and production in numerous ways. However, to achieve this increase in competitive capabilities, these networks have to be exclusionary. In other words, domestic or foreign firms that do not belong to the production networks face obstacles in their efforts to enter or expand in many Asian markets because they are often deterred from entering, or effectively barred from establishing, trading relations with firms in the networks. This is especially true in those markets in which network members have a large market share. Put differently, more and more markets in Asia are becoming like the many Japanese markets that are extremely difficult to enter.

Before arriving at the preceding arguments, we conducted numerous interviews with government and business leaders, in Japan and elsewhere in Asia. This was necessary because despite their importance for our analysis no reliable data exist on quantity, price, and product category of trading conducted within regionally based manufacturing groups (i.e., among firms of the same *keiretsu* in Japan and among firms belonging to the same production network in Japan and elsewhere in Asia).¹⁸ Interviewees provided unique observations and insights for our efforts to understand the motivations and effects of Japan’s increasing presence in Asia. Unlike most neoclassical economists, who would regard the responses of interviewees as “anecdotal,” and thus of little value, we believe these responses provide a valuable contribution to a study such as this. The usefulness of these responses will be fully demonstrated in the next section.

¹⁷ We recently came across the following description of *keiretsu* by Ikko Shimizu, a widely read novelist of “economic novels” who is known for his acute insights into Japanese business. It pithily captures the condition of the subcontractor who must depend so heavily on his parent firm. “The *keiretsu* system is like a greenhouse. Those of us raised in it live on rationed feed called work. We turn into hothouse hybrids and lose the technical and the managerial means for independence in the competitive business world outside.” Ikko Shimizu, *The Dark Side of Japanese Business*, Armonk, NY: M. E. Sharpe, Inc., 1996, p. 193. This is a translation of Shimizu’s three short stories by Tamae K. Prindle. For an extended analytic discussion of “bargaining power” and “hostages,” see Chapter Three, “Cooperation between Unequals,” of our *Asia in Japan’s Embrace*, *op. cit.*, pp. 43–61.

¹⁸ Every three years, Japan’s Ministry of International Trade and Industry (MITI) publishes its *Kaigai jigyo katsudo kihon chosa* (Basic survey of overseas business activities), which includes an entry on “transactions within the same enterprise group.” MITI, however, allows survey respondents to define what an “enterprise group” is. Most seem to define it as a fully integrated corporation, rather than a *keiretsu* or network. Japanese scholars, such as Kazumasa Iwata, have called on the Japanese government to provide data on intra-network transactions.

II. The Findings of the Follow-up Study

In mid-1995, we launched a follow-up study to our book, *Asia in Japan's Embrace*, with two goals. One was to determine whether we needed to revise our analysis in light of new developments. These developments included the deepening of the post-“bubble” recession in Japan (and the consequent slowdown in capital investment within Japan), the sharp *endaka* (appreciation of the yen) that began in the spring of 1995 (to as high as 80 yen to a dollar), the spurt of new business activities in Asia by seemingly reinvigorated American high-tech firms, particularly electronics manufacturers, and the emergence of Asian MNEs, including not only South Korean and Taiwanese firms but also the much-ballyhooed enterprises run by the so-called overseas Chinese of Southeast Asia.

The other motivation for conducting a follow-up study was to fill part of the lacunae that we knew existed in our book. In particular, we hoped to examine more closely the impact of Japan's increasingly large economic presence in Asia on rival multinational enterprises, particularly American MNEs. To what extent are those rival multinationals being disadvantaged by the exclusionary character of Japanese MNE-controlled regional production networks? The follow-up study found that, while efforts to regionalize Japanese developmentalism have been affected in different ways by new realities, our original analysis remains fundamentally sound.

On the supply side, Japanese capital continues to flow into Asia in impressive amounts (\$7.76 billion in manufacturing investment in 1995—a 57-percent increase over the volume in 1994 and more than double the amount in 1993);¹⁹ more and more Japanese manufacturers are moving into the region (a net increase of 662 firms in 1995, according to one estimate);²⁰ these firms are consolidating their networks as they, in the words of the Japanese government, “scatter their production bases throughout the region based on the relative merits of each host country and try thereby to achieve a division of labor within Asia”;²¹ and the government itself, which still provides a very large volume of ODA to Asian nations, continues to back Japanese MNE efforts to build and strengthen these production networks in significant ways.²²

On the demand side, Asian countries continue to rely heavily on Japanese technology to fuel their increasingly export-oriented economies. In 1994, 52.3 percent of Malaysia's technology was

¹⁹ If data collected by different countries using different methods can be usefully compared (and this is, admittedly, a huge leap of faith in statistics), Japanese manufacturers are investing twice as heavily in Asia as American manufacturers. In 1995, U.S. manufacturing FDI in Asia was \$3.71 billion, according to the Department of Commerce, *Survey of Current Business*, vol. 76, no. 7, Washington, D.C.: U.S. Government Printing Office, July 1996. At the end of 1995, Japan's cumulative total manufacturing investment in Asia was \$28.2 billion, while the United States' was \$18.5 billion. Source for the Japanese data is Ministry of Finance, *Heisei shichi-nen ni okeru taigai oyobi tainai chokusetsu toshi jokyō* (Report on inward and outward direct investment in 1995), an unpublished document released “over the counter” in June 1996.

²⁰ Toyo Keizai Shinposha, *Kaigai shinshutsu kigyō soran*. Other good sources of information on investment flows into Asia are various *hakusho* (white papers by the Japan External Trade Organization (JETRO), among others), *Wagakuni kigyō no kaigai jigyo katsudo*, MITI's annual report on “The overseas business activities of Japanese firms,” *Kaigai toshi tokei soran* (Comprehensive statistics on Japanese foreign investment), which MITI publishes every three years, and *Kaigai chokusetsu toshi no kyōka todokede jisseki* (Statistics on approval/notification of overseas direct investment), published annually by the Ministry of Finance (MOF). *Kaigai jigyo katsudo jittai chosa* (A survey of overseas enterprise activities), published in 1994 by the Small and Medium-Sized Enterprise Agency of MITI, contains much useful data on current and projected domestic and overseas output and investment by size of firm. Other nongovernmental sources include *Ekonomisuto* and *Nihon keizai shimbun* (which also has an on-line service).

²¹ Japan External Trade Organization, “Zai ASEAN nikkei kigyō seizogyō no rokuwari ga arata na toshi o keikaku” (Sixty percent of Japanese manufacturing affiliates in ASEAN are planning to undertake new investment), *JETRO deirī* (JETRO Daily), April 16, 1996, p. 12. This trend is also discussed in MITI, *Wagakuni kigyō no kaigai jigyo katsudo, dai ni-ju yon kai*, which includes a section on “Kodoka, nettowaakuka suru kaigai jigyo katsudo” (Technology upgrading and network-forming overseas business activity), pp. 24–28; and in MITI, *Tsusan hakusho, Heisei hachi-nen* (White paper on international trade, 1996), which notes on page 144 that the rapid expansion of Japanese parts suppliers into Asia in the 1990s has allowed Japanese manufacturers to break their production processes into discrete but interconnected pieces.

²² Ministry of Foreign Affairs (Japan), *Wagakuni no seifu kaihatsu enjō no jishsho jokyō, 1996*, Tokyo: Association for the Promotion of International Cooperation, 1996.

imported from Japan, compared with 22.7 percent from the United States.²³ In 1995, Taiwan was importing 57 percent of its new technology from Japan and 28 percent from the United States.²⁴ While Taiwan has become one of the world's leading manufacturers of notebook computers, it has done so only with the help of Japanese know-how. For example, in 1995, Japan supplied more than 90 percent of the liquid crystal display panels installed in notebook computers manufactured in Taiwan.²⁵

Asia's chronic dependence on Japanese technology shows up starkly in bilateral trade figures. Because it relies so heavily on Japanese capital and intermediate goods, South Korea—one of Asia's most advanced economies—saw its trade deficit with Japan climb from \$10.8 billion in 1994 to \$14.1 billion in 1995.²⁶ But Korea was not alone. Despite the most recent and relatively dramatic round of yen appreciation, and contrary to repeated forecasts by the Japanese government and confident predictions by neoclassical economists, Asia's collective trade deficit with Japan rose again in 1995. Specifically, it jumped another \$8.4 billion (to \$71 billion) from its already high level of \$62.6 billion in 1994. This annual increase, we should note, is larger than the total trade deficit Asia had with Japan in 1985 (\$8.2 billion).²⁷

We are not suggesting that Japan's trade surplus with Asia will remain forever at or above its current level. Rather, we are arguing that Japanese government officials and neoclassical economists erroneously continue to forecast a rapid decline in Asia's trade deficit with Japan because they underestimate the amount of Japanese exports to Asia of capital goods and intermediate products needed to build the Japanese MNEs' production networks, and overestimate the amount of Asian exports to Japan—an amount that can increase significantly only to the extent that such Asian exports serve the interests of established *keiretsu* networks within Japan.²⁸

The issue of enduring consequence, of course, is the mix of products traded, not the trade balance itself. As long as a significant number of Asian firms operate as subcontractors, integrated vertically into Japanese MNE-controlled production networks, Asia's exports, whatever the relative magnitude, will likely consist primarily of manufactured products with less value-added than those produced by Japanese firms in Japan. Imports from Japan, again whatever the relative magnitude, will consist primarily of higher value-added manufactured products.²⁹ This, of course, is the anticipated outcome of "captive development."

If anything, Japanese multinational enterprises have in the last few years redoubled their efforts to replicate *keiretsu* networks in Asia, extending their reach into and across the region. They are doing so, in part, by prodding their Japanese suppliers to follow them overseas. This fact is well documented in the annual surveys of overseas investors conducted by the Export-Import Bank of Japan. In 1995, when asked to identify the factors prompting them to undertake FDI, 24 percent of the Japanese affiliates in the Asian newly industrialized economies (NIEs), 33 percent of those in the ASEAN-4 (Malaysia, Indonesia, Thailand, and the Philippines), and 21 percent of those in China indicated that they had been motivated by a need to "supply parts to an assembler." Five years earlier, in 1990, only seven percent of those operating in the NIEs, four percent in the ASEAN-4, and zero percent in China had mentioned this as a motivation for in-

²³ MITI (Malaysia), *Malaysia International Trade and Industry Report*, July 1995, p. 193.

²⁴ Ministry of Economic Affairs, Investment Commission, Republic of China, *Statistics on Overseas Chinese and Foreign Investment, Technical Cooperation, Outward Investment, Outward Technical Cooperation, and Indirect Mainland Investment*, May 1995, pp. 50–51.

²⁵ *Far Eastern Economic Review*, January 11, 1996, p. 73.

²⁶ MITI (Japan), *Tsusun hakusho* (White paper on international trade), 1996.

²⁷ *Ibid.*

²⁸ See Robert Z. Lawrence, "How Open is Japan?" in Paul Krugman, ed., *Trade with Japan: Has the Door Opened Wider?* Chicago: University of Chicago Press, 1991.

²⁹ For a comparison of the trade patterns between Japan, the United States, and Europe in East Asia, see Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace*, *op.cit.*, pp. 175–91.

vestment.³⁰ It may also be useful to take note of the rapid increase in overseas investment, particularly in Asia, by Japan's small and medium-sized enterprises. In fact, 92 percent of the FDI undertaken by such enterprises in 1995 went to Asia, where many (but not all) of these enterprises operate as *keiretsu* suppliers.³¹

This trend—what one might call the “*keiretsu*-ization” of Asian manufacturing industries—is noted routinely and without fanfare in both popular and scholarly publications in Japan. (This may have something to do with the fact that, for most Japanese, if not for most policymakers and scholars outside Japan, the term *keiretsu* is a familiar expression without any opprobrious connotation.) Thus, in *Forum*, a magazine published quarterly by the Japanese Automobile Manufacturers Association, Yuri Sato writes matter-of-factly that in Indonesia, “the core of the parts supply system for Toyota vehicles consists of in-group Astra firms with close ties to Japan in terms of capital and technology. This represents an effective *keiretsu* relationship, centered in this case on the Toyota group.”³² The Astra Group is Indonesia's largest auto assembler, enjoying more than 50 percent of the market share in that country, thanks to the participation of Toyota, Daihatsu, and Isuzu.³³

One can readily appreciate the extent of *keiretsu* networking in Asia by studying the directories of Japanese chambers of commerce in places such as Bangkok.³⁴ The *sogo shosha*, or general trading companies, often sit at the core of such networks, serving as matchmakers and dealmakers. Mitsubishi Shoji and Mitsui Bussan, two of Japan's largest general trading companies, each have more than 180 joint ventures in Thailand.³⁵

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New research supports our assertion that Japanese multinational enterprises maintain exceptionally tight control over their network members—both formally affiliated manufacturers and more informally related suppliers—throughout the region. In a 1995 survey conducted in Taiwan, for example, half of the Japanese affiliates indicated they had to “strictly” follow their parents' lead on marketing matters, whereas American affiliates enjoyed far more latitude to make their own sales decisions. In addition, Japanese affiliates in Taiwan's electronics industry reported that they engaged in intra-firm trade more extensively than their American counterparts.³⁶

Structured interviews, which provide a microscopic view into the business practices and procedures of Japanese MNEs in Asia, also tend to back up our contention.³⁷ For example, an Indonesian executive who used to work for a Daihatsu-controlled automobile joint venture in

³⁰ Research Institute on Overseas Investment (an arm of the Export-Import Bank of Japan), *Ex-Im Review*, various years.

³¹ MITI, *Chusho kigyo hakusho, 1996* (White paper on small and medium-sized enterprises).

³² Yuri Sato, “Japan's Role in the Southeast Asia Automobile Industry,” *Forum*, vol. 14, nos. 3 and 4 (February 1996), p. 15.

³³ *Ibid.*

³⁴ To more rigorously measure the extent of such networking, one also could review annually published volumes such as *Kigyo keiretsu soran*, Tokyo: Toyo Keizai Shimposha; and *Kaisha tokei nenkan*, Tokyo: Toyo Keizai Shimposha, containing data on the amount of capital invested and the names of directors.

³⁵ *Far Eastern Economic Review*, February 1, 1996, p. 47.

³⁶ The Taiwan data were gathered as part of a multi-country study coordinated by the Institute of Southeast Asian Studies in Singapore. Tu Jenn-hwa, an economist at National Taiwan University, shared preliminary results with the authors.

³⁷ As the quotations indicate, interviewees discussed the issue of control in different ways. Some, usually Japanese interviewees, spoke obliquely, while others, usually non-Japanese, spoke more directly.

Jakarta offered this first-hand account of a Japanese management team tightly tethered to the home office: “Everything comes from Tokyo. They [the Japanese managers in Indonesia] cannot make any decision locally. I still remember how Daihatsu’s local people consulted every day, for many days, with their superiors in Tokyo over how to cope with price competition from Suzuki and Mitsubishi in the pickup and minivan markets. It was an unbelievably long process.”³⁸

Japanese MNEs are able to exert such control over affiliates in Asia, as well as local subcontractors in the region, for at least one of two reasons. First, in many cases, they or the networks they oversee are the sole or major purchaser of the product manufactured by their local affiliates and subcontractors in Asia. And second, the Japanese MNEs are in most instances the primary suppliers of capital, technology, and managerial guidance to those affiliates and subcontractors. At both ends of the production pipeline, then, these parent firms operate as oligopolists, wielding enormous bargaining power in relationships marked by quasi-integration.

What does this mean for host economies? Using econometric as well as anecdotal evidence, we asserted in our book that Japanese MNEs, relative to Western MNEs, hang onto their technology for a longer period because they rely on such relational contracting, rather than spot-market transactions, for so much of their international business activity. As a result, they thwart the logic of the “flying geese” theory of economic development, which assumes that technology diffuses rapidly from developed countries to developing countries as the former exports to, and then invests in, the latter.³⁹

Our follow-up study generally supported the book’s conclusion. We heard compelling evidence that Japanese MNEs hire fewer local managers for sensitive positions (such as purchasing and marketing) than Western MNEs, but try harder to keep them inside the firm once they do. In addition, we came across overwhelming evidence that Japanese MNEs rely more heavily on Japanese rather than indigenous or “native” suppliers, but try harder to maintain long-term relationships with those domestically owned suppliers with whom they do contract business.⁴⁰ The net effect is to impede the otherwise rapid diffusion of technical know-how from Japan to developing economies in Asia.

In more than a dozen interviews conducted in several countries, we continued to hear criticism that Japanese MNEs are “irritatingly slow” or “particularly reluctant” to transfer their technology.⁴¹ For example, the principal consultant for investment promotion in Hong Kong’s Government Industry Department remarked, “Japanese manufacturers are, like American manufacturers, transferring technology here, but at a much slower rate. They try hard to maintain control of everything.”⁴² And Hu Chung-ying, deputy director of sectoral planning in Taiwan’s Council for Economic Planning and Development, told us that “Japan is not willing to transfer

³⁸ The interviewee asked to remain anonymous. Interview, July 4, 1995, Jakarta.

³⁹ The classical statement of the “flying geese” theory is Kaname Akamatsu, “A Theory of Unbalanced Growth in the World Economy,” *Weltwirtschaftliches Archiv*, vol. 86, no. 2 (1961), pp. 196–215. Japanese government officials, as well as many economists, routinely invoke this theory when they discuss Japan’s role in promoting regional economic development. Vernon’s product cycle theory, which also anticipates technology diffusion, is very similar. See Raymond Vernon, “International Investment and International Trade in the Product Cycle,” *Quarterly Journal of Economics*, vol. 80 (1966), pp. 190–207. A solid critique of both theories, as they (fail to) apply to Asia, is Mitchell Bernard and John Ravenhill, “Beyond Product Cycles and Flying Geese: Regionalization, Hierarchy, and the Industrialization of East Asia,” *World Politics*, vol. 47, no. 2 (January 1995), pp. 186–87.

⁴⁰ This conclusion is shared by Wendy Dobson, *Japan in East Asia: Trading and Investment Strategies*, Singapore: Institute of Southeast Asian Studies, 1993; and in the preliminary findings for Taiwan in the regional study coordinated by the Institute of Southeast Asian Studies on multinational business activity in Asia.

⁴¹ How slow is too slow? How reluctant is too reluctant? This is, of course, a matter of judgment. Some scholars who agree that Japanese MNEs are unusually slow to localize their Asian operations also express optimism that the pace may be increasing. See, for example, Wendy Dobson, *Japan in East Asia*, *op. cit.*, and Dieter Ernst, “Carriers of Regionalization: The East Asian Production Networks of Japanese Electronics Firms,” *op. cit.*

⁴² Interview, July 21, 1995, Hong Kong.

the most important technology. It's disappointing and frustrating. Taiwanese firms pay a lot of money on royalty fees, but get very little in exchange."⁴³

If such complaints were true, then one might well expect to find local firms frantically cutting deals with Western MNEs in Asia. In some industries (such as telecommunications) and in some markets (such as Singapore), they are. But in many others, they are not. Domestically owned firms often are unwilling to break long-term, *keiretsu*-like relationships with Japanese multinational enterprises, even though they may be assigned a bit part in the Japanese MNE-controlled regional production network within their own economy. They prefer the certain reality of profits in the here and now over the uncertain prospect of technology acquisition in the future. With all of this in mind, our follow-up study sought to measure the extent to which Japan's production networks are "exclusionary." Specifically, we asked whether these *keiretsu*-like networks preclude or inhibit entry by "outsiders," particularly rival MNEs from the United States.

In one sector, motor vehicles, the answer is unambiguous. From Jakarta to Taipei, Japanese automakers are the region's undisputed insiders, and they wield enough clout to maintain their privileged status.⁴⁴ In Thailand, where Toyota is reportedly "oozing confidence" as it pushes to achieve its goal of producing 30 percent of all cars by the year 2000, the government continues to adopt regulations only after consulting with the Thai automobile industry, which means the Japanese assemblers (particularly Toyota) and their suppliers.⁴⁵ The chairman of the Thai Automotive Industry Association, Ninnart Chaithirapinya, is a senior managing director for Toyota Motors Thailand. And as of late 1995, the president of the Thai Autoparts Manufacturers Association, Nattavat Praepriwngam, was a leading advisor to the Toyota Cooperation Club, the automaker's supply *keiretsu* in Thailand.⁴⁶

It thus came as no surprise to Bill Kennedy, regional sales manager for Chrysler International in Thailand, that, when the government recently asked these groups to review national emission standards, "they began to focus on a certain engine configuration that just happened to accommodate Toyota" but did not accommodate Chrysler. As a result, Chrysler found itself "unable to market a bunch of vehicles because they no longer met Thai standards."⁴⁷

For Chrysler executives, what happened in 1995 was far from unprecedented. For example, in 1991, when Chrysler tried to introduce the Jeep Cherokee into Thailand, the Thai government treated the 4x4 sport utility vehicle as a luxury car. As a result, it imposed a hefty excise tax of 38 percent, even though it already had tagged Mitsubishi's rival 4x4, the Pajero, as a pickup truck, thus qualifying it for a more favorable identification carrying a tax of only ten percent. U.S. officials ultimately intervened on Chrysler's behalf and succeeded in persuading Thai officials to give the two utility vehicles equal treatment. But those negotiations dragged on for three long years, during which time Mitsubishi enjoyed a substantial price advantage over Chrysler.⁴⁸

In Malaysia, too, where Mitsubishi has guided production of a "national car," the government still tightly restricts the number of licensed assemblers. For Diego Torres, Chrysler's chief representative in Kuala Lumpur, this means that, to participate in local production, he must contract with an assembler "whose loyalty, naturally, is with the people who have been in the

⁴³ Interview, July 17, 1995, Taipei.

⁴⁴ A former General Motors executive in Indonesia went so far as to say that, "If I disclosed our confidential business plans to the ministry in the afternoon, the Japanese would know everything by dinner time." Telephone interview with Len Brownfield, September 19, 1995.

⁴⁵ "Toyota Shrugs Off American Car Rivals; Oozing Confidence with 30 Years of Presence Here," *Bangkok Post*, July 26, 1996.

⁴⁶ In 1996, Pramot Pongthong succeeded Nattavat as president of the Thai Autoparts Manufacturers Association. Pramot is president of Wichien Dynamic Industry Co., which supplies parts to Nissan and Volvo.

⁴⁷ Interview, July 8, 1995, Bangkok.

⁴⁸ Michael J. Dunne, "Keys to the Kingdom of Asia," *Asian Wall Street Journal*, June 28, 1995.

country the longest, not with us." In other words, the Japanese have what Torres called "a far better deal. They're grandfathered in."⁴⁹

Japanese [automobile] assemblers also exploit their dominant market position in much of Asia by pressuring their suppliers and distributors to do business only with them.

Japanese assemblers also exploit their dominant market position in much of Asia by pressuring their suppliers and distributors to do business only with them. This should surprise no one familiar with the recent history of *keiretsu* relationships in Japan. Nonetheless, Len Brownfield, the former head of General Motors' operation in Indonesia, had not expected his entrenched Japanese rivals to play such hardball to protect their huge (about 90 percent) market share. "I had seven well-established guys lined up to be new Chevy-Opel dealers. But one by one, they mysteriously fell out. In the end, none of them would agree to work with us. They told me privately that [a Japanese manufacturer for whom they do almost all of their business] had threatened to cut off their supply if they did."⁵⁰

Tim Suchyta, director of Chrysler's regional operations, has bumped into a remarkably similar brick wall. For several years, Chrysler has been negotiating with leading suppliers in Southeast Asia, trying in vain to secure solid contracts for key parts. "It's been quite difficult to get access to the Japanese joint venture suppliers," Suchyta stated. "We had some outright rejections that made absolutely no business sense at all. In Malaysia, for example, we had an AC [air conditioning] supplier who simply refused to have anything to do with us. It seemed pretty clear that he had been instructed to just say no." By default, Chrysler now must contract with domestically owned suppliers, whose productivity levels and quality standards are in almost all cases lower than those of Japanese suppliers. This, Suchyta explained, "puts us at a great disadvantage."⁵¹

Auto parts manufacturers face an even more difficult time establishing a foothold in the Asian market. To import separate parts, such as forgings, they must pay duties that far exceed anything the large Japanese assemblers of completely knocked down kits must pay.⁵² In general, those parts makers are required to manufacture to Japanese specifications and must compete against Japanese joint-venture firms whose parents are longstanding members of supply *keiretsu* established in Japan. This is why James Henderson, marketing director of Johnson-Matthey HICOM (a British producer of the catalyst used in catalytic converters) observed that "I don't see a hell of a lot of opportunities for non-Japanese parts makers. Unless they can cut a deal with the automakers in Japan to be incorporated into their regional networks, they're going to be locked out."⁵³

Johnson-Matthey HICOM, which has won approval to manufacture catalysts for the Proton, Malaysia's national car, is an exception. Malaysian officials apparently prevailed upon Mitsubishi Motors, which oversees production of the Proton, to allow non-Japanese firms to supply some of the lower value-added parts. Henderson realizes he is lucky. "The catalyst has to be certified by the government. Other parts, from shock absorbers to starter motors, have to win the concurrence of the Japanese assembler. Parent firms in Japan are not all that interested in using non-Japanese suppliers. They view such a prospect as just another possible source of disruption."⁵⁴

⁴⁹ Interview, July 6, 1995, Kuala Lumpur.

⁵⁰ Telephone interview, September 19, 1995.

⁵¹ Interview, July 12, 1995, Bangkok. Toyota is equally protective of its suppliers in Taiwan, according to Harry Wong, head of public relations for General Motors in Taipei. Interview, July 17, 1995, Taipei.

⁵² Facsimile from Roy Swagger, vice president of business development, Dana Spicer, October 4, 1995.

⁵³ Interview, July 8, 1995, Kuala Lumpur.

⁵⁴ *Ibid.*

Representatives of other parts makers confirmed this pessimistic outlook. TRW, a large American supplier, is a partner in a tripartite joint venture in Taiwan with Japanese and Taiwanese firms. But managers at its factory “insist on using all Japanese materials,” said a TRW official who asked to remain unnamed. “We have no alternative. The Taiwanese managers here all speak Japanese and have relationships that go way back.”⁵⁵ Dana Spicer, a large American auto parts firm, is trying hard to establish itself in the region, particularly in Thailand and Taiwan. But Roy Swagger, vice president for business development in Bangkok, was as gloomy as he was terse. The Japanese assemblers, he wrote, do not solicit bids and “are not generally receptive to bids” from Spicer.⁵⁶

The automobile industry is clearly the worst case for American manufacturers in Asia. But investment, output, and export data confirm that it is far from being the only case in which Japanese firms dominate markets in the region. Japanese MNE production networks also are firmly established in the consumer electronics and appliance industries in Southeast Asia. And despite explosive growth in demand, Japanese manufacturers have maintained or perhaps even tightened their grip on these markets. For example, in Indonesia, Sanyo—the leader of that country’s electronics industry—has just invested another \$50 million to build a new plant to produce refrigerators and other household appliances. This kind of financial commitment intimidates potential rivals. “If we wanted to build an appliance plant here, we’d have to really think twice,” confided Ram Sharma, who recently retired as head of General Electric, Indonesia. “The market is so sewed up, it might not be worth it. We looked at the idea ten years ago and decided we were too late. We looked at it again five years ago and decided we were even later. Now we’re looking at it again.”⁵⁷

For American firms, the machine tool industry is another sad case. In a 1994 study, the U.S. Embassy in Bangkok found that U.S. manufacturers accounted for only 4 percent of all machine tool sales in Thailand and that Japanese manufacturers accounted for 68 percent. However, the study also found that the Thai market was growing at a torrid rate of 20 percent a year. Encouraged by that forecast, Roy Hensley, the CEO of American Machinery and Equipment Co., immediately agreed to represent a consortium of U.S. machine-tool manufacturers in Thailand. In 1995, after more than a year of phone calling and flesh-pressing, Hensley finally sold his first piece of equipment. “The Japanese are formidable opponents, that’s for sure,” said Hensley. Echoing the sentiments of U.S. automakers, he alleged that Japanese tool makers in Asia have maintained market power partly by enforcing exclusionary contracts with their suppliers. To buttress this claim, he told how he tried to approach NMB, the Thai subsidiary of Japan’s Minebea, the world’s leading manufacturer of precision ball bearings, on behalf of a U.S. manufacturer. “They wouldn’t even give me an appointment. I told them I had an American client who wanted to do an awful lot of business with them. But they weren’t interested. They said they were busy, at full capacity, just trying to keep up with their Japanese customers. They told me I had to deal with their parent firm in Japan.”⁵⁸

This experience is increasingly common. In 1995, JETRO (Japan External Trade Organization), an arm of the Japanese government, conducted a survey of 67 foreign (but non-Japanese) electronics firms operating in Malaysia. Nearly half said they had had some business transactions or technology tie-ups with Japanese parent companies in Japan, but only about a quarter

⁵⁵ Interview, July 14, 1995, Taipei.

⁵⁶ Facsimile, October 4, 1995. A decade ago, Dana Spicer also tried to break into the Indonesian market. An attorney in Jakarta who represented the firm at that time recalls that Spicer had tried to sell standardized parts in compliance with host government policy to foster the growth of independent suppliers. “The Japanese were not interested. They flatly refused to buy.” (Interview, July 4, 1995, Jakarta.) Spicer ultimately had to abandon the market.

⁵⁷ Interview, June 30, 1995, Jakarta.

⁵⁸ Interview, July 10, 1995, Bangkok.

(27 percent) had had any dealings with Japanese affiliates that, like them, had moved into Malaysia. Eighty percent of those foreign (but non-Japanese) firms who had not had any dealings with their Japanese counterparts indicated that they would like to.⁵⁹

Japanese producers control important markets not only in Southeast Asia, but often also in Northeast Asia. Consider the case of Taiwan. According to Alan Turley, deputy chief of the commercial section at the surrogate American embassy in Taipei, “If you want to sell a machine tool, or plastic molding equipment, or medical equipment, you have to deal with the Japanese. They’re very strong in the market for industrial machinery—from pumps to compressors.”⁶⁰ Bruce Berkman, general manager of Productivity Asia, a business consulting firm in Taipei, attributed much of Japan’s success in this nuts-and-bolts field to the high level of intra-group cooperation between Japanese firms, particularly between mammoth trading companies and small manufacturers belonging to the same *keiretsu*. In his words: “Say, for example, that Formosa Plastics wants to build a naphtha cracker. A trading company will make a bid for a whole system, such as pumping. Then they’ll go out and find the pump manufacturers, the pipefitting firms, and the rest, and farm out all the work to their *keiretsu* members.”⁶¹

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On the other hand, we found that U.S. firms have managed to hold their own in several important industries in Asia—including semiconductors, computers, and computer peripherals—and appeared in mid-1995 to be waging increasingly successful battles against Japanese firms. Seagate, which uses 21,000 Thai workers to manufacture hard disk drives for the U.S. market, has become the biggest foreign private sector employer in Thailand.⁶² Intel, Motorola, National Semiconductor, and AT&T are, along with Germany’s Siemens and Japan’s NEC, the leading chip makers in Singapore.⁶³ This was a dramatic change from the late 1980s, when Japanese electronics giants were using low-cost capital from their “bubble” economy to finance expensive research and development (R&D) projects at home and build high-volume manufacturing facilities in Asia and the rest of the world. But the “bubble” burst, and Japanese high-tech firms became vulnerable. With banks in Japan struggling to avoid collapse, high-tech manufacturers found they could no longer count on vast reservoirs of financial credit. As the recession deepened and *endaka* accelerated, many of these firms had to scramble to remain internationally competitive.

The result was that, in a small number of industries, Japanese multinationals began to look a bit more like the American and European multinationals that, by comparison, tend to transfer relatively high technology and to trade with other firms on the basis of spot prices, rather than long-term relationships. For example, in 1995, three Japanese high-tech firms announced plans to build facilities in the Hsinchu Science-based Industrial Park south of Taipei, thus doubling the number of Japanese firms investing in the park since it opened in 1980.⁶⁴

⁵⁹ “Nikkei kigyo to no kankei kyoka e iyoku o miseru gaishikei kigyo” (Foreign affiliates that are showing a desire to strengthen ties with Japanese affiliated firms), *JETRO deirii* (JETRO daily), April 30, 1996.

⁶⁰ Interview, July 13, 1995, Taipei.

⁶¹ Interview, July 18, 1995, Taipei.

⁶² American Chamber of Commerce, Thailand, *Handbook Directory*, p. 287.

⁶³ Interviews with government and business leaders, July 5, 1995, Singapore.

⁶⁴ “Fleeing Yen, Japan Builds High-Tech Plants in Taiwan,” *Asian Wall Street Journal*, July 4, 1995, p. A1.

Until this development, Japanese manufacturers in Taiwan had preferred to locate operations in export-processing zones, which, unlike the science park, are not tightly integrated into the domestic economy and do not require investors to conduct R&D.⁶⁵ While some moved to set up R&D facilities in Asia for the first time, other Japanese MNEs indicated they would try to upgrade the technological capabilities of their Asian affiliates—a fact confirmed in several interviews and observed by several contributors to a special issue on the “hollowing out” of Japan’s economy in *Ekonomisuto*.⁶⁶

In addition, a handful of Japanese high-tech producers began to do business with “outside” suppliers—primarily Western firms that do not belong to Japanese production networks. George Carey, vice president of marketing for ASTEC Custom Power, a British firm that supplies sophisticated electrical transformers to computer manufacturers in Asia, was pleasantly surprised in 1995 to finally penetrate the once-solid walls of Japanese networks. In the past, he noted, his approaches had been summarily repelled. “It was impossible to sell to them.” Carey, who had been stationed in Hong Kong and now is in the Philippines, had become inured. “They had a standard line: ‘We already have excellent suppliers. They know our system and serve us well. Thanks anyway.’ That’s the way it worked. Now, though, they have begun to deal with us.”⁶⁷

Carey’s good fortune was caused by market forces, particularly the high production costs associated with the latest round of *endaka*. Japanese computer manufacturers felt compelled to look to outsiders who could offer lower prices than those of longstanding *keiretsu* insiders.⁶⁸ “They first went to their established vendors in Japan and told them they had to lower their prices. But the vendors couldn’t do it. They were already totally squeezed. So they [Japanese computer producers] realized they had to deal with us foreign barbarians.”⁶⁹

A year later, however, Japanese computer makers seemed to be falling into old patterns, retying the knot with many of their longtime *keiretsu* suppliers. Two factors caused this change. First, the yen depreciated to a more comfortable level (107–114 to the dollar), lifting some of the price pressure on Asian affiliates importing parts from Japan. And second, Japanese suppliers acted quickly, and en masse, to establish their own plants in Asia, thereby reducing production costs. Carey, contacted again in the fall of 1996, emphasized this point. “We are still having considerable success because [the market] is a bit more open,” he wrote in response to a follow-up inquiry. “But it’s not as easy as it looked like it was going to be since the Japanese suppliers have gotten themselves more competitive.”⁷⁰

Jeff Mowla, managing director of AT&T Microelectronics in Singapore, knows all too well that Japanese suppliers moving so aggressively into a new market stand a good chance of dominating it in the end. He has seen how suppliers embedded in production networks cornered the market on piece parts for semiconductors, allowing them to pass on the costs of *endaka* to their non-Japanese customers. Today AT&T buys virtually all of its piece parts—the gold wire, lead frames, and mold compound for its semiconductors—from Japanese suppliers in Singapore or from parent firms in Japan. “It’s starting to become a serious concern,” said Mowla. “The IC [integrated circuit] marketplace is now exceedingly tight. Everyone is queuing up for parts, so

⁶⁵ H. “Steven” Hsieh, director of the park, advises against reading too much into these announcements. “I don’t know if this is really a new trend or just a temporary blip. It’s too early to say.” Interview, July 15, 1995, Taipei.

⁶⁶ “Kudoka shinkoku” (Acute “hollowing”) section, *Ekonomisuto*, November 14, 1995, pp. 36–58.

⁶⁷ Interview, July 21, 1995, Hong Kong.

⁶⁸ Japanese MNEs also found themselves chased by American computer makers, such as Apple and Dell, riding highly aggressive pricing policies, and by Microsoft, which had just introduced a popular, relatively cheap, Chinese character-based operating system. Japan’s leading personal computer maker used a proprietary operating system that worked only on its computers and that was quite expensive.

⁶⁹ Carey’s analysis is amply supported by a stream of government and mass media reports on unilateral moves by cost-conscious parent firms to force their subcontractors to slash parts prices.

⁷⁰ Electronic mail correspondence with George Carey, September 21, 1996.

suppliers are in the driver's seat. We have been pounded by some really big price increases due to the yen's appreciation. This is a time in which I would cherish the presence of strong suppliers from other countries. Unfortunately, though, the others are still not quite able to deliver what we need. So I don't have a lot of choice."⁷¹

In some high-tech industries, then, Japanese *keiretsu*-like networks in Asia actually have grown stronger, not weaker. Although new realities, such as the sudden *endaka* of mid-1995 and the heightened challenge from American electronics manufacturers, have forced Japanese MNEs in the region to scramble, they have begun to find ways to cut costs and regain competitiveness without abandoning their relatively closed networks. (The fact that, in 1996, the yen fell back to earlier levels has, of course, helped them achieve this outcome.) The race for market share and strategic advantage in Asia is not, after all, a 100-meter dash, a short-run jockeying for position. As Japan's leading manufacturers seem to know, it is more like a marathon, a long-run struggle based on dynamic technological efficiency—that is, based on the ability to increase investment consistently and to adopt or develop new technology.

On this score, we should recall the not-too-distant past. In the 1970s, Japanese manufacturers rebounded relatively quickly from the supply shock of spiraling oil prices. And in the 1980s, they defied the doomsday forecasters once again by reorganizing and retooling to cope with a doubling of the yen's value. Thus we should not be surprised to learn that, in the 1990s, Japanese MNEs are drawing on accumulated strengths to consolidate their Asian networks. Just as it did in earlier periods, the Japanese government is playing an important, albeit supporting, role in this process. JETRO, which has staff spread throughout the region, uses administrative guidance to help coordinate the activities of Japanese multinational enterprises as they expand into Asia. Other governmental agencies—such as the Export-Import Bank of Japan and the Japan Finance Corporation for Small Business—are helping to finance Japanese FDI. Private groups such as the Japan International Development Organization and the Japan Asia Investment Co., both launched with government support and guided by economic ministries in Tokyo, also provide financing to Japanese firms investing in Asia.⁷²

Not only does the Japanese government guide Japanese firms operating in Asia, it also tries to guide host governments in the region, especially in Southeast Asia.

Not only does the Japanese government guide Japanese firms operating in Asia, it also tries to guide host governments in the region, especially in Southeast Asia. It is, in this way, exercising what has been called "leadership from behind," a quieter, softer form of hegemony in which Japan's distinctively public-private institutions help overcome collective action problems and achieve regional consensus around important economic issues.⁷³ Officials of the Japan International Cooperation Agency, one of Tokyo's two aid-implementing agencies, are stationed throughout the region, gathering valuable information and giving equally valuable advice to host government officials.

⁷¹ Interview, July 5, 1995, Singapore.

⁷² Ming Wan and Susan Pharr discuss this form of "public-private aid" in a paper, "Japan's Leadership: Shaping a New Asia," written in April 1996 for the Association for Asian Studies conference in Honolulu.

⁷³ Richard Doner, "Japan in East Asia: Institutions and Regional Leadership," a paper for the Project on Japan in Asia, Cornell University, May 10, 1995.

For example, when we visited Malaysia's Ministry of International Trade and Industry (MITI) in Kuala Lumpur, officials were reviewing a report on the country's auto parts industry. The report, which called for improving the quality of Malaysian auto parts by, among other things, attracting new investment, was written by a Japanese bureaucrat with his own office in the Malaysian MITI building.⁷⁴ Japan's MITI is currently engaged in several projects designed to bolster Japanese production networks in Asia. For example, it is hoping to establish industrial standards in the region that are compatible with Japanese manufacturers, while trying to persuade other Asian countries to use Japan's patent system as the model for their own.⁷⁵ In addition, Japan's MITI is pursuing a plan to develop a small passenger plane somewhere in Southeast Asia in cooperation with other members of ASEAN.⁷⁶

Besides offering recommendations on everything from industrial to macroeconomic policy, Japan also uses more direct means—cash—to exercise leverage in the region. Even in academic circles, Japanese influence is highly visible. The Center for Japanese Studies at the University of Indonesia recently built a new complex with a \$10 million grant from the Japanese government.⁷⁷ And the Center for Japan Studies at the Institute of Strategic and International Studies in Kuala Lumpur is financed in part by the Keidanren, Japan's big business lobby. Roger Bertelson, managing director of Motorola Malaysia, is both impressed and appalled by this influence-purchasing. "The Japanese give money above the board, on the board, and below the board."⁷⁸

Official development assistance is one of the most important "above the board" routes Japanese money takes into Asia. In 1995 alone, Tokyo gave \$5.75 billion in foreign aid to Asia, including \$1.38 billion to China, \$892 million to Indonesia, \$667 million to Thailand, and \$416 million to the Philippines.⁷⁹ Although Japanese government officials proudly and accurately note they have "untied" most of their yen loans, allowing host governments to hire non-Japanese firms to carry out Japanese-financed development projects, frustrated executives of U.S. firms continue to complain they rarely get a piece of such action. For example, Otis Elevator had hoped to win at least part of a \$35 million contract to install elevators, escalators, and travelators at the new Kuala Lumpur International Airport, which is being built with Japanese ODA. Instead, the Japanese contractors managing the project awarded it to Mitsubishi and Hitachi. Nandu Madireddi, Otis' chief representative in Malaysia, just shrugs as he discusses his company's unsuccessful bid. "The inclination for Japanese contractors is to use Japanese subcontractors. They're more familiar and therefore more comfortable with them."⁸⁰

In Beijing, IBM had hoped to obtain a contract for a project financed by ODA to design and build an electronic payments system for the People's Bank of China. In fact, it was so eager to build a relationship with the bank that, according to an IBM executive, it submitted a bid that fell well below its anticipated cost of completing the project. Even so, the job went to NTT Data, a Japanese firm. John Burgoyne, general manager of IBM Asia Pacific Corp., could not disguise his disappointment. "The Chinese like to spread the wealth around, to award business in terms of political relationships and largesse. Right now, they're favoring the Japanese."⁸¹

⁷⁴ We were not allowed to review the report for ourselves, but its contents were summarized very briefly by Raihan Sharif, assistant director of the industrial policy division, in an interview, July 7, 1995, in Kuala Lumpur.

⁷⁵ *Nihon keizai shimbun*, September 20, October 9, and October 10, 1996.

⁷⁶ *Yomiuri shimbun*, October 12, 1996.

⁷⁷ Interview with Dorodjatun Kuntjorojakti, Dean of Social Sciences, University of Indonesia, July 3, 1995, Jakarta.

⁷⁸ Interview, July 7, 1995, Kuala Lumpur.

⁷⁹ Ministry of Foreign Affairs, *Wagakuni no seifu kaihatsu enjo no jissho jokyo*, 1996. "Asia" here includes South Asia (India, Pakistan, Bangladesh, and Sri Lanka). Those who would argue that Japanese ODA is no longer driven by economic self-interest should read this report. In it, the Ministry of Foreign Affairs—which is the least "mercantilist" of the agencies administering Japan's foreign aid program—argues that this program is designed not only to help developing economies, "but also to support the lifestyle of Japanese people themselves" (p. 2). Specifically, it asserts that Japanese ODA will expand markets for Japanese exports and investment.

⁸⁰ Interview, July 6, 1995, Kuala Lumpur.

⁸¹ Interview, June 27, 1995, Beijing.

It should be noted that other MNEs, particularly Asian multinationals, have begun to establish their own footholds in the region. In 1994, Taiwan was the leading source of foreign investment in Malaysia, while Hong Kong investors led the pack in Indonesia.⁸² And as many trend-watchers have observed, overseas Chinese business groups in Southeast Asia are beginning to make inroads into such places as China and Vietnam.⁸³

Still, there are several good reasons to think twice before concluding that multinationalization by investors from newly industrializing economies or the ethnic Chinese soon will eclipse Japan's economic presence in Asia. First, FDI flows fluctuate sharply from month to month, and even year to year. Longer-run trends clearly show Japanese production capacity on the rise in Asia. Indeed, in the first quarter of 1995, Japan again emerged as the leading source of foreign manufacturing investment in Indonesia.⁸⁴

Second, NIE and overseas Chinese investment in Asia is qualitatively different from Japanese investment. A study by a trio of Taiwanese economists concluded that Taiwanese investment is, more often than not, "defensive FDI," which is designed to escape rising labor costs at home, rather than "expansionary FDI," which is designed to capitalize on strategic advantages in marketing, management, or technology.⁸⁵ In general, NIE operations in Asia are labor-intensive, relatively low-tech, and not well integrated into networks coordinated by a central actor, such as the parent company.⁸⁶

This is even truer in the case of ethnic Chinese multinational enterprises, which invest more heavily in services and real estate than manufacturing. Of the 17 biggest overseas Chinese families with regional business operations, only two invest heavily in unregulated, high-tech industries.⁸⁷ The family patriarchs who run these operations generally identify themselves as Indonesian or Thai, not Chinese, and often cannot communicate verbally with one another because they or their ancestors came from different areas of China and thus speak completely different dialects. Deals that are struck tend to be ad hoc and free-floating.

If one wishes to call these relationships "networks," then one should understand them as Michael Borrus does. "Chinese networks," he writes, "tend to be open, flexible, and disposable."⁸⁸ Du Jin, an economics professor at Liaoning University in China, characterizes them in a similar way. "When we examine trading patterns among ethnic Chinese firms, we discover that they frequently engage in short-term, strategic trade not only with related firms, but with firms controlled by a different parent. In contrast, Japanese firms engage far less frequently in 'horizontal' trade across enterprise groups, because they have such strong 'vertical' *keiretsu* ties."⁸⁹

⁸² Taiwanese FDI in Malaysia that year was a little more than \$1 billion, while Japanese FDI was \$667 million. MITI (Malaysia) *Malaysia International Trade and Industry Report*, 1995. Hong Kong FDI in Indonesia that year was about \$6 billion, while Japanese FDI was \$1.6 billion. Investment Coordinating Board, Indonesia, "Statistics on Investment, Up to May 31, 1995."

⁸³ An example of the burgeoning literature trumpeting (and, we think, overblowing) the rise of overseas Chinese "networks" is John Naisbitt, *Megatrends Asia: Eight Asian Megatrends that are Reshaping our World*, New York: Simon and Schuster, 1996.

⁸⁴ Investment Coordinating Board, Indonesia, "Statistics on Investment, Up to May 31, 1995," *op. cit.*

⁸⁵ Tain-jy Chen, Yi-ping Chen, and Ying-hua Ku, "Taiwan's Outward Direct Investment: Has the Domestic Industry Been Hollowed Out?" in Nomura Research Institute and the Institute of Southeast Asian Studies (ISEAS), *The New Wave of Foreign Direct Investment in Asia*, Singapore: Institute of Southeast Asian Studies, 1995. The Taiwanese government shares this view. In a 1993 report ("Economic Revitalization Program: An Action Plan for the Promotion of Private Investment"), the Council for Economic Planning and Development blamed a slowdown in domestic manufacturing investment on labor-intensive producers who, faced with a rising wage bill, chose to invest abroad rather than upgrade technology at home.

⁸⁶ South Korean MNEs may be an exception. See "Going Global," *Far Eastern Economic Review*, November 2, 1995.

⁸⁷ John Micklethwait, "The Search for the Asian Manager," *The Economist*, March 9, 1996, p. 11.

⁸⁸ Michael Borrus, "MNC Production and East Asian Integration: A Research Note," Berkeley Roundtable on the International Economy, University of California, November 1994, p. 3. The contrasting investment styles and firm behavior between ethnic Chinese and Japanese-owned MNEs are extensively documented and examined in Toshio Watanabe, ed., *Kajin keizai nettowaaku* (The networks of Chinese economy), Tokyo: Jitsugyo no Nihonsha, 1994. *Kajin* in the book title refers to ethnic Chinese.

⁸⁹ *Nihon keizai shimbun*, February 3, 1996, p. 22.

This raises the third and final point about the NIE and ethnic Chinese multinationals in Asia: many have been incorporated as subordinates into Japanese production networks. Taiwanese firms, in particular, often invest abroad to carry out original equipment manufacturing services on behalf of Japanese technology suppliers.⁹⁰ And ethnic Chinese business groups often rely on Japanese trading companies to help them make business deals—even in places such as China, where they supposedly have an advantage.⁹¹ In other words, while many Asian MNEs suddenly have considerable access to capital, some still have to depend on the more established Japanese MNEs for technical know-how and business connections.

. . . China itself. . . poses a huge challenge for Japanese multinational enterprises. Here they are playing catch-up with well-established Western firms in the automobile and electronics industries.

But China itself, we must acknowledge, poses a huge challenge for Japanese multinational enterprises. Here they are playing catch-up with well-established Western firms in the automobile and electronics industries. Until recently, Japanese MNEs had invested about as much in this huge market as they had in Taiwan, an island with less than two percent of China's population. And when they did invest, they tended to crowd into export-processing zones in the northeastern province of Liaoning, the site of the former Japanese-controlled Manchukuo. In these enclaves, Japanese firms typically fabricated inputs that came from Japan and then shipped finished goods back home or sold them to other countries.⁹²

Now, however, this peculiar pattern of investment is beginning to change. Japanese firms, particularly small suppliers, are moving into China at a breakneck pace. Cumulative Japanese FDI in China, which had been only \$3.5 billion in 1992, jumped to \$8.7 billion in 1994 and then to \$13.2 billion in 1995.⁹³ In addition, more and more Japanese manufacturers are beginning to produce not just for re-export, but for the rapidly growing China market.

Given their track record in the rest of Asia, one would be foolish to dismiss the efforts being made by Japanese MNEs as they try to set up shop in China. For one thing, many of these small suppliers are able to capitalize on their *keiretsu* ties with large manufacturers such as Matsushita and Daihatsu. As Inamura Raiji, chief representative of Japan's Export-Import Bank in China, explains: "If they were independent, they would not have the financial and informational resources to come here. But being subcontractors, they are able to rely on a very broad support network."⁹⁴

While some American business executives managing successful operations in China appear smug, those who have watched the Japanese in action know better. Richard Kahler, president of Caterpillar China, was general manager for Caterpillar Indonesia until 1994. He recalled that Japanese heavy equipment manufacturers persuaded their hometown suppliers to follow them into Indonesia and provide just-in-time delivery of key parts. In addition, the Japanese befriended top officials in the Indonesian bureaucracy, helping them obtain more sympathetic treatment on

⁹⁰ See Bernard and Ravenhill, "Beyond Product Cycles and Flying Geese," *op. cit.*

⁹¹ Itochu has paved the way into China for Thailand's Charoen Pokphand group, while Marubeni has done the same for Indonesia's Salim group. The Japanese trading companies, it seems, have better business and political connections in China than some of Southeast Asia's biggest "Chinese" conglomerates. *Far Eastern Economic Review*, February 1, 1996, p. 47.

⁹² U.S. Embassy, Beijing, "Japanese Investment in Dalian: Interest in an Old Favorite Continues," March 14, 1995; and "Opportunity Knocks: Dalian Has Become a Haven for Japanese Companies," *Far Eastern Economic Review*, December 8, 1994, p. 56.

⁹³ Ministry of Finance, *Heisei nana-nen ni okeru taigai oyobi tainai chokusetsu toshi jokyō* (The status of outward and inward direct investment in 1995), Tokyo: Ministry of Finance, June 1996.

⁹⁴ Interview, June 26, 1995, Beijing.

licensing and contract issues. It was, he said, a successful strategy, and Kahler suspected that his Japanese rivals would pursue the same or a similar one in China.

Kahler is confident, but not over-confident, about Caterpillar's ability to withstand a Japanese challenge in China. "We have a pretty solid strategy, and I think we'll just continue to follow it and not be too terribly concerned about what others are doing. That does not mean, however, that we will rest easily. We should always bear in mind that they [the Japanese] can move very fast once they've decided to move."⁹⁵

Lauren Giglio, former head of Beijing Chrysler, agrees that, even for well-positioned American MNEs in China such as Chrysler, the battle has now been joined. "The Japanese will pay a dear price for being so slow to invest here, but they will find a way to get in. They always seem to find a way. I really don't worry about them doing well. They will. What I worry about is us falling behind the eight ball even further."⁹⁶ Giglio spoke not long after Toyota secured approval to become the sixth foreign automaker (after Chrysler, Volkswagen, Peugeot-Citroen, General Motors, and Mercedes Benz) to manufacture passenger vehicles in China.⁹⁷

III. Policy Implications

If our analysis is correct, Japan today is pursuing developmentalism by building *keiretsu*-like production networks that it dominates both across the region and within each host economy. To be sure, these *keiretsu* networks differ in significant ways from their domestic counterparts in Japan because, for example, *keiretsu* networks in Asia can be, and have in many instances been, more effectively challenged by multinational firms of other nations than those in Japan; some governments of the host economies can, and do, adopt policies restricting the behavior, thus the market power, of *keiretsu* networks in Asia; and building and maintaining close and dependable *keiretsu* ties in Asia is more difficult (i.e., costly) than in Japan because of the many socio-cultural differences among Asian nations (including language, social norms, and the like).

Unless a specific policy is adopted, we will see in Asia in the coming decades what we have already witnessed in Japan: extreme or substantial difficulties for non-Japanese foreign firms wishing to enter markets dominated by keiretsu networks.

It is indisputable, however, that Japanese MNEs have built production networks in Asia in the automobile, auto parts, electronics, machinery, and other important industries, and these networks continue to be expanded and strengthened. Unless a specific policy is adopted, we will see in Asia in the coming decades what we have already witnessed in Japan: extreme or substantial difficulties for non-Japanese foreign firms wishing to enter markets dominated by *keiretsu* networks. Recall that, by the 1980s, when American scholars belatedly began to discuss the trade effects of *keiretsu*, it proved extremely difficult, if not virtually impossible in some cases, for foreign manufacturers in key industries to expand market share by exporting to or investing in Japan because of the well-established and exclusionary *keiretsu* networks. Given the total size of the Asian markets today and the continuing growth of the Asian economies, the costs of such entry barriers, if re-erected across the region, will be even higher to non-Japanese companies in Asia.

⁹⁵ Interview, July 20, 1995, Hong Kong.

⁹⁶ Telephone interview, September 14, 1995.

⁹⁷ *Nihon keizai shimbun*, February 7, 1996, p. 11.

As we have stressed, these *keiretsu* ties have in numerous ways benefited Asian firms, and thus Asian host economies. In the long run, however, they may begin to impose costs as economies “embraced” by Japanese capital and technology become “captives” that: (1) being recipients of carefully rationed technology, must content themselves with producing goods of distinctively lower technological levels according to the global strategies of Japanese MNEs; and (2) having handed over “hostages” (large investments in human and physical capital dedicated exclusively to supplying products to the parent firm in a *keiretsu*), must endure the harsh contract terms (prices, delivery schedules, etc.) offered by Japanese MNEs with enormous market power.

Some Asian leaders have begun to show signs that they recognize the risk of becoming excessively dependent on Japanese capital and technology. In the early 1990s, for example, Prime Minister Mahathir Mohamed of Malaysia made a move to strengthen his bargaining position with Japanese automakers who have dominated two national car projects in his country. Specifically, he negotiated alternative technology licenses with Western multinationals such as Citroen of France and Rover of England. This does not, however, reflect any intention to cut the umbilical cord through which Malaysia receives valuable technology from Japan. Mahathir, long known for strongly advocating a Japanese “model” for his country, made that clear when he renewed his commitment to high-profile, long-run technology cooperation agreements with Mitsubishi Motors and Daihatsu.

Likewise, in 1996, President Soeharto of Indonesia struck a blow against Japanese automakers by authorizing the tariff-free import of vehicles manufactured in South Korea under a so-called “national car” project. Kia Motors is producing the car under a contract with PT Putra Timor National, an Indonesian firm controlled by one of Soeharto’s sons. There is little doubt that a principal intent of Soeharto’s action was to spur Japanese as well as Western firms to invest more aggressively in the Indonesian automobile industry, which could be swamped with imported cars and parts from Thailand once a proposed ASEAN Free Trade Area begins to take effect and reduces tariffs in 2003.

For most Asian nations, though, being aware of the high risk of becoming “captives” does not mean they can cease to depend on what Japan provides (capital, technology, market, managerial expertise, etc.). The reality is that, despite the few instances we have noted above, Asian nations are competing for what Japan can offer and they remain extremely reluctant to openly criticize or take any actions that might offend Japanese MNEs or the Japanese government.

For example, a high official in one of South Korea’s economic ministries (who asked to remain anonymous) told us he is convinced that Japanese *keiretsu* subsidiaries and affiliates aggressively use transfer pricing to avoid corporate taxes in Korea, and acknowledged that his government could enforce existing laws more strictly to curb such practices. But for diplomatic reasons, it chooses not to. “We try not to ruffle their [Japanese] feathers even though we know we are losing some tax revenue. Not collecting all the taxes due to us is a small price to pay for their help with technology, capital, and most importantly with their orders.” In the same way, Asian leaders from Bangkok to Taipei tend to muffle their complaints about bilateral trade deficits with Japan. They know that the capital goods and intermediate products they import from Japan are fueling the export-oriented growth these countries have enjoyed since the mid-1980s. (We should add here that the mirror image of Asia’s widening trade deficit with Japan is its soaring trade surplus with the United States—a surplus that has climbed steadily from less than \$30 billion in 1985 to \$63.2 billion in 1995.)

It is evident that the United States is the only nation with sufficient interest (in terms of the amount of American FDI in Asia and Asia-U.S. trade) and political muscle to counter effectively Japan’s emerging and deepening production alliance in Asia. As a first step toward a far-sighted policy, the U.S. government should move to create, at the earliest opportunity, a mechanism that

It is evident that the United States is the only nation with sufficient interest and political muscle to counter effectively Japan's emerging and deepening production alliance in Asia.

performs the functions of an ombudsman to hear and take actions on (1) exclusionary practices by multinational firms (both Japanese and non-Japanese) maintaining vertically or horizontally integrated production and/or distribution networks, and (2) “strategic alliances”—intercorporate joint efforts (in production, distribution, R&D, etc.) across national borders between large MNEs (and their subsidiaries)—which can, and often do, substantially increase market power of the allied firms within a national, regional, or even international economy. We should note here that if an alliance is formed exclusively among all or most firms in an industry of a single nation (as is the case of alliances for several types of auto parts that have been formed exclusively by Japanese automakers in Asia), the collective market power possessed by such an alliance can substantively impede market access to the firms in the same industry of other nations.⁹⁸

The actions that should be taken include establishing facts, asking the firms involved (or the government of the firms and/or the host economy) to change practices, and, in cases of non-compliance, initiating a process of dispute resolution through the mechanisms of the World Trade Organization (WTO). The mechanism to act as an ombudsman can be an office established within each American embassy in Asia (as already is the case in the U.S. Embassy in Japan) or, better still, an office for all members of the Asia-Pacific Economic Cooperation (APEC) forum that is maintained collectively by the nations within APEC.

Closely related to the above is a recommendation we add here parenthetically. We believe the United States needs to pursue with utmost care the case of entry barriers in Japan's film market (Kodak vs. Fuji), currently moving forward through the dispute resolution process of the World Trade Organization (WTO). This is an important case in which the WTO can establish a precedent (regarding the methods of objectively determining what types of activities are conducted within a distribution *keiretsu*) for future cases involving exclusionary practices of *keiretsu* firms and *keiretsu*-based production alliances. We are aware that this will be a difficult undertaking because *keiretsu* ties are often implicit or informal rather than explicit, and change over time. However, these facts themselves help demonstrate why the best effort of the United States is needed in establishing a precedent useful for future cases.

In making such antitrust-related recommendations, we believe it is important to remind American policymakers of the following historical reality. Japanese firms come to Asia from an antitrust environment substantially different from that in the United States. As many have observed (and has been an issue in U.S.-Japan trade disputes), Japan had no antitrust law before the Antimonopoly Act of 1947, and enforcement of the act remains weak. The 1953 amendment and a dozen industry-specific laws permitted a large number of cartels to be organized and many other forms of noncompetitive activity that would be judged collusive under American laws (e.g., preferential dealing with firms with which cross-shareholding and/or interlocking directorates are maintained). In short, Japan's antitrust environment, thus the mind-set of Japanese executives, differs sharply from its American counterpart.⁹⁹

⁹⁸ For excellent analytic and technical discussions relating to antitrust concerns of “strategic alliances” and cross-border market power, see F.M. Scherer, *Competition Policies for an Integrated World Economy*, Washington, D.C., Brookings Institution Press, 1994.

⁹⁹ For a thorough discussion contrasting the antitrust environment of Japan and the United States and the effects of the differences on firm behavior and public policy in Japan and the United States, see Kozo Yamamura, “Joint Research and Antitrust: Japanese vs. American Strategies,” in Hugh T. Patrick, ed., *Japan's High Technology Industries*, Seattle: University of Washington Press, 1986, pp. 171–209.

The United States must also closely and systematically monitor whether contracts for ODA-supported projects in Asia are awarded on a “fair and open” competitive basis and do not benefit, directly or indirectly, the commercial interest of the firms of the nation providing the ODA. This monitoring is especially important for projects supported by Japanese ODA because we found sufficient and credible evidence that these projects are, in an overwhelming majority of instances, awarded to Japanese firms.¹⁰⁰ And, as noted in the preceding sections, when Japanese ODA projects are undertaken by Japanese MNEs and their subsidiaries, the inevitable outcome is to help increase the market power of Japanese firms and production networks over time and to disadvantage non-Japanese firms in various direct and indirect ways. Of course, when all donor nations award contracts for all ODA projects on a fair and open basis, the donor nation’s ability to use its ODA for the benefit of its own firms will be substantively reduced and the likelihood of ODA-projects serving the needs of the recipient nations will be increased.

To adopt any of the foregoing recommendations means that the United States needs to take leadership in initiating APEC-wide efforts to collect reliable data essential in accurately understanding all important economic activities. No one today is able to determine accurately, for example, the extent of intra-firm and intra-*keiretsu* trading (which increasingly crosses borders); the amount of nonrepatriated earnings that is reinvested in host economies; the total amounts of tax preferences received by MNEs of differing nationalities (i.e., tax avoidance engaged in by MNEs under tax laws and provisions of the host economies); and the amount of ODA projects undertaken by an MNE or by an MNE-led *keiretsu* firm. Due to these data limitations, current research relies too heavily on sample surveys, which contain many types of serious biases and usually are unable to answer adequately important questions relating to firm behavior, market power, and the distributions of gains and losses between firms and nations.

All of the preceding leads us to recommend that the United States take the initiative, ideally within the APEC framework, to establish international teams of specialists to examine objectively the long-term benefits and costs of business activities pursued in Asia by both Japanese and non-Japanese MNEs, as well as the merits and demerits of official activities pursued by both Japanese and non-Japanese governments interested in the region. Comparative analysis, as well as reliable data, is sorely needed.

Finally, before concluding this essay, we should take note of two policy suggestions that were made at the recent Manila APEC meetings (November 21–24, 1996).

First, the trade ministers of the APEC nations agreed to create an independent mechanism of APEC by which all economic disputes among members nations are to be solved. The procedure agreed upon is: the disputing member nations attempt to solve the dispute; if the disputing parties fail to reach a solution within 60 days, “high-level” trade officials of member nations act as mediators to solve the dispute; and if the mediation effort fails, the “high officials” will designate a dispute settlement panel consisting of specialists. Furthermore, it was agreed that the entire process is to take no more than 290 days.

Although this suggestion requires further refinements before it can be implemented, if it is put into effect as intended it will create a dispute resolution mechanism (that is a replica of the WTO mechanism) within APEC. If this proposal is in fact implemented, the “ombudsman” mechanism we suggested above can be made a part of this APEC dispute resolution settlement mechanism. For the reasons noted above, the United States needs to take the initiative in bringing about such a modification to the proposal.

¹⁰⁰ See Walter Hatch and Kozo Yamamura, *Asia in Japan’s Embrace*, *op.cit.*, pp. 39, 122, 127, and 131–37.

Second, not waiting until 2003 as agreed at the last annual meeting, APEC member nations formally agreed, effective immediately, to accept applications for tariff reduction (to a maximum of five percent) of manufactured products meeting specific conditions (local content of 40 percent and local capital participation rate of 30 percent). This means multinational firms can now produce a product in a member nation and export it to other member nations paying little or no tariff.

According to *Asahishimbun*, Japan's major daily newspaper, reactions to this decision by the Japanese automakers are "very enthusiastic" because they will be able to increase further the "concentrated" production of auto parts within a member nation and export them to another member nation. This decision is an additional boost to Japanese automakers in their efforts to maximize the gains of region-wide production networks. They already benefit from so-called BBC (brand-to-brand complementation) tariff relief (by 50 percent of the tariff rate in effect if a local content requirement of 50 percent is met) which has been in effect since 1988. Japanese multinational enterprises having production bases in Asia "immediately began to prepare to apply for tariff relief under this decision" in the interest of "concentrating production of various parts" within a member nation.¹⁰¹

The immediate reduction in the intra-APEC tariff rate will undoubtedly contribute to strengthening the industrial and export capabilities of the APEC members as the reduced tariff can attract more FDI and enable manufacturing firms in the region to increase their productive efficiency. However, the decision to reduce intra-region tariffs immediately suggests to us that the APEC nations must be even more watchful of the market power that can be gained by multinational firms operating within the region. That is, as the region becomes more integrated (i.e., few or no tariffs and a rapidly increasing cross-border trade), the need to closely scrutinize the gains of free trade and the likelihood of large firms (or a group of firms) gaining "undue market power" (in the vocabulary of American antitrust laws) rises. For reasons already stressed, this means that the United States now has even more reasons to exert leadership in creating an antitrust mechanism.

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economic growth will not remain open long.*

The most crucial fact that must be stressed in concluding this essay is that the recommendations we have made need to be adopted as expeditiously as possible because the window of opportunity for the United States to adopt a farsighted policy and for American firms to participate more effectively in the ongoing Asian economic growth will not remain open long. If we fail to seize this opportunity, we will again encounter in Asian markets, as we did in Japanese markets during the last three decades, trade barriers that are difficult and often politically and economically costly to overcome. If the Asian economies are to continue to grow, keeping their destinies in their own hands, and if the American economy is to grow and prosper into the next century, the United States must have the responsibility as well as the substantive interest to adopt a farsighted policy to best assure that Asian markets remain open to all.

¹⁰¹ The descriptions of the decisions made at the Manila meeting as well as the quoted remarks in this appended section are based on *Asahi shimbun*, November 21, 1996, p. 11. On the BBC tariff reduction and its effects on the behavior of Japanese automakers in the region, see Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace*, *op. cit.*, pp. 35 and 186.