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PART ONE

Co-Prosperity Again

CHAPTER ONE

Crossing Borders: The Japanese Difference

At corporate headquarters in Osaka, Shuzui Takeo, director of Asian operations for Matsushita, draws a series of little circles on a sheet of paper. Then, with a few quick strokes, he ties the circles together in a grid of criss-crossing lines.

Shuzui is trying to demonstrate how he and his colleagues at Matsushita, the mega-maker of electrical and electronic goods bearing names such as National, Panasonic, Technics, and Quasar, hope to meld the company's 60 manufacturing plants in East and Southeast Asia into a more tightly integrated network. The new approach coincides with a plan by members of ASEAN to gradually reduce duties on products imported by one country from another in Southeast Asia.

"Over the next five years," Shuzui says, "we must restructure our operations to achieve a kind of intraregional division of labor, or functional specialization. That means concentrating production of single products or parts in different factories in different countries, and exporting most of the output to other markets."[1]

Malaysia, according to this strategy, might serve as the company's regional production base for air conditioners and refrigerators, Thailand as headquarters for washing machines, Singapore as the center for color televisions, and so on. The ultimate decision on where to locate each production activity, Shuzui says, "would be based on each country's strengths." If successful, the Matsushita strategy would enable the company's Asian operations to achieve economies of scale, scope, and networking, allowing it to manufacture and export products that could compete more effectively in markets throughout the world.

In his Tokyo office, Nishina Akira, head of Southeast Asian operations for Mitsubishi Electric, is stewing. He knows about Matsushita's plan, which he regards as an all-out assault on his own company's less developed network in Southeast Asia. Mitsubishi Electric manufactures air conditioners, refrigerators, televisions, video cassette recorders, and assorted electronic components at factories in Thailand, Malaysia, and Singapore. "We must position ourselves to meet that challenge," Nishina says.[2]

The Mitsubishi executive has been promoting a counterstrategy to integrate the company's regional operations, to build an equally or even more effective network that assumes the entire world as its marketplace. His is a new idea, and new ideas are not always welcome. Especially not in such a large organization.

"It's a big headache for me," Nishina confides. "The managers [of Mitsubishi Electric affiliates in Southeast Asia] just want to hold onto the local markets they already control and continue to earn the high profits they have been earning. They must learn to see the bigger picture, the global picture."

Matsushita and Mitsubishi are not the only Japanese multinational corporations (MNCs) trying to outmaneuver one another in Asia. In fact, the region is buzzing with a competitive energy that is more than a little reminiscent of the *katō kyōsō*, or "excessive competition," that marked the rapid growth period (1950–73) in Japan. Just as they did then, high-volume, high-technology manufacturers are racing to invest in new or expanded production facilities, increase output, reduce costs, boost exports, and grab larger and larger shares of the global market. Each manufacturer enters this regional rat race, just as it might have entered the domestic investment chase of the 1950s and 1960s, backed by two mutually reinforcing insurance policies. One is issued by the government, which uses its extralegal powers of "administrative guidance" (*gyōsei shidō*) to manage the competition. The other, even more basic, coverage comes from the *keiretsu*, the firm's own network, which spreads out the cost and risk of doing business in a highly competitive and uncertain environment.

In this book, we argue that Japan has embraced the Asia-Pacific region in a *keiretsu*-like production alliance. Although the Japanese government, as we shall demonstrate, has used its influence in Japan and in the region to build such an alliance, Japanese MNCs such as Matsushita and Mitsubishi have supplied the actual bonding agents – capital and technology. In fact, the alliance we refer to is nothing more than the complex web of vertically integrated production networks spun across Asia by the many different high-technology firms seeking to expand their market power by capturing the returns on their investment in innovation. At the same time, though, it is nothing less than a coordinated effort to lock up the productive resources of the world's most dynamic region.

Others before us have used similar terms and concepts to describe what Japan is doing in Asia. Impressed by a heavy flow of intraregional trade, the Ministry of International Trade and Industry (MITI) has, for example, identified something it calls a "soft cooperation network." Takeshi Aoki, an economist for Japan's Institute for International Trade and Investment, has referred to a "core strategic network"[3] created by the multidirectional flow of Japanese investment and trade.[4] And Hisahiko Okazaki, former ambassador to Thailand, has said Japan is setting up "an exclusive Japanese market in which Asia-Pacific nations are incorporated into the so-called *keiretsu* system." The relationship is cemented by the trade of "captive imports, such as products from plants in which Japanese companies have invested" for "captive exports, such as necessary equipment and materials."[5]

These descriptions, by themselves, do not add up to a comprehensive analysis. But they do deserve some consideration because they run counter to the prevailing view expressed by most neoclassical economists that Japan is really doing nothing extraordinary at all in Asia, except perhaps to plug into the region's economic energy.[6] We intend to demonstrate that Japan is doing much more than that.

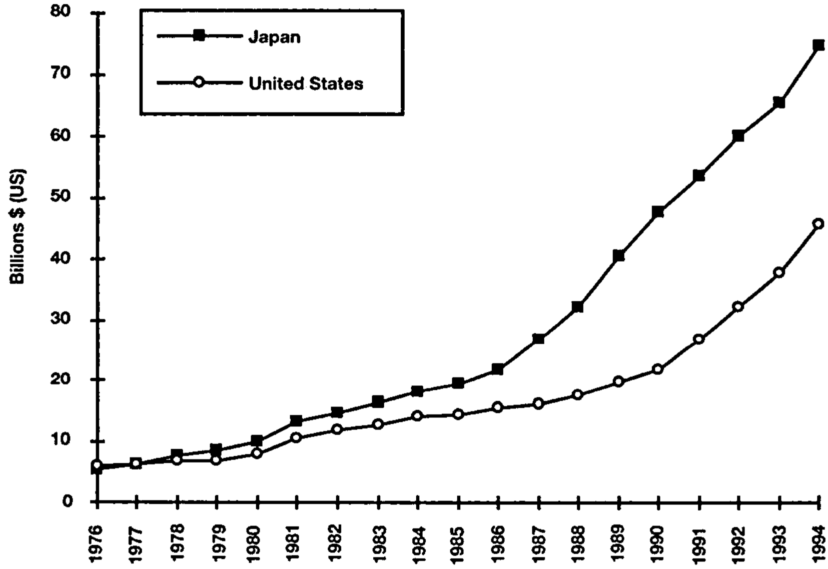

Figure 1.1 Japanese and US FDI in Asia
Source: U.S. data from Department of Commerce; Japanese data from Ministry of Finance.

Numbers

It is difficult to quantify the depth and breadth of a technology-based production alliance. Most studies of Japanese economic expansion into Asia have focused on the flow of capital, or foreign direct investment (FDI). As Figure 1.1 shows, in 1977 Japan's FDI stock in the region was roughly equivalent to that of the United States (at less than $6 billion). But 17 years later, in 1994, its cumulative FDI had grown more than twelvefold to $74.7 billion, while America's had increased to only $45.7 billion.[7] And despite the prolonged recession that began in Japan in 1990, Japanese investment in Asia has continued to increase rapidly. (Although Siemens [Germany], Thomson [France], and Philips [the Netherlands] are among the leading investors in Asia, European FDI as a whole has not been a force of late. In fact, Taiwanese, Korean, and even Singaporean investors outpaced the Europeans on FDI in Asia in the late 1980s and early 1990s.)

Japan's FDI in Asia, we concede, is only a fraction of its total overseas investment. As of 1994, Asia had received only 16.1 percent of cumulative Japanese FDI. North America, by comparison, had received 43.7 percent, while Europe had snared 19.4 percent.[8] Nonetheless, Japanese investment in East and Southeast Asia's relatively small host economies packs a disproportionately powerful punch. In Thailand, for example, Japanese affiliates accounted for about 40 percent of *total* (foreign and domestic) start-up investments in 1990 and 1991.[9] By 1994, about 7 percent of Thailand's production workers were employed by Japanese firms.[10] In Malaysia, one Japanese firm – Matsushita – accounts for nearly 4 percent of the entire country's GNP.[11]

We should also note that Japanese FDI in developing Asia has different characteristics from Japanese FDI in developed regions. For one thing, it is geared more to production. A 1995 survey found that manufacturers represented 53 percent of all Japanese-affiliated firms in Asia, but only 31.6 percent and 20.7 percent of the Japanese firms in the United States and Europe, respectively.[12] So we should not be surprised to learn that 36 percent of Japanese manufacturing investment (and nearly three-quarters of the projects) in 1994 went to the Asian NICs, the ASEAN-4, and China.[13] (Figure 1.2 documents the increasing flow of Japanese manufacturing FDI to Asia from 1985 through 1994, as well as the evolution of "favorite" destinations: first the NICs, then the ASEAN-4, and then China. The trend lines, however, do not reflect reinvestments, which have been robust all over Asia.) In addition, small and medium-sized firms from Japan are more active in the Asia-Pacific region than they are in other parts of the world. And as Figure 1.3 shows, they are increasingly active there. In 1994, 81.3 percent of small and medium-sized firms investing overseas opted to go to Asia.[14] As a result, by 1994

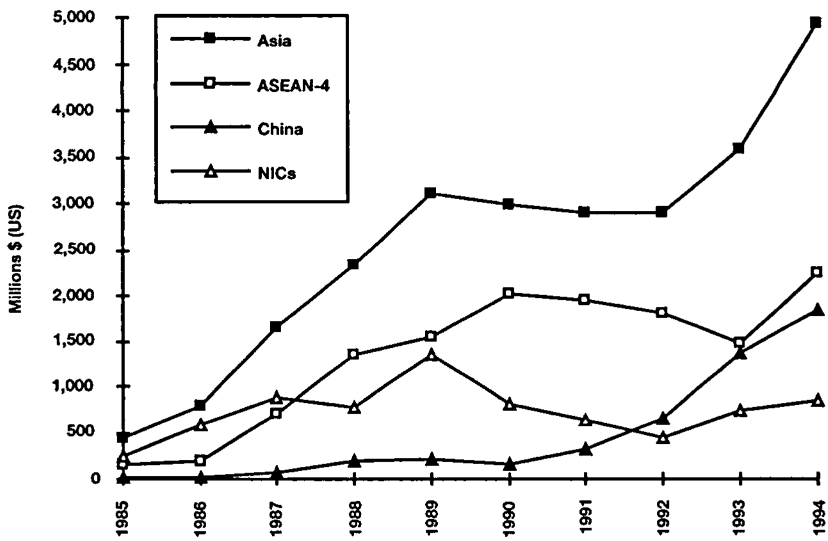

Figure 1.2 Japanese Manufacturing FDI in Asia
Note: These figures do not include reinvestments.
Source: Ministry of Finance.

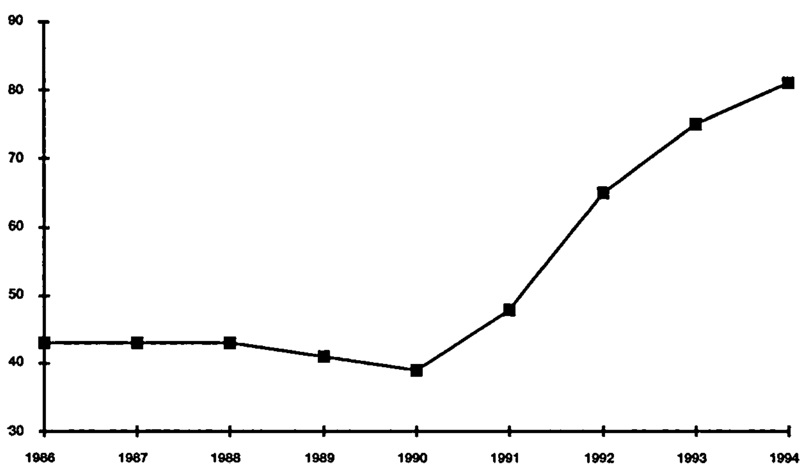

Figure 1.3 Share of Total FDI by Japanese SMEs Going to Asia
Source: MITI, *Chūshō kigyō hakusho*, various years.

there were almost as many Japanese affiliates in the Asia-Pacific region as there were in North America and Europe combined.[15] And in certain industries, especially high-tech industries such as electrical machine manufacturing, there were far more. As of 1994, there were 800 Japanese affiliates in Asia manufacturing electrical machinery. There were 413 in the United States and Europe combined.[16]

Table 1.1 Japan's Technology Exports to Asia

Year	Volume ($ billions)	Share of Japan's total exports (%)
1986	0.69	38
1987	0.69	40
1988	0.81	41
1989	1.03	39
1990	1.23	45
1991	1.36	46
1992	1.33	44
1993	1.49	47

Note: "Asia" includes India and Pakistan. Figures are based on a constant exchange rate of ¥125 = $1.
Source: Science and Technology Agency, *Kagaku gijutsu hakusho*, 1993, p. 348; and Management and Coordination Agency, *Kagaku gijutsu kenkyū chōsa hōkoku*, 1994, p. 168.

Table 1.2 Japan's Manufacturing Technology Exports to Asia (1993)

Types of machinery	Number of cases	Volume ($ millions)	Share of Japan's total exports (%)
General	561	67.9	57
Electrical	1,142	705.5	55
Transportation	565	378.5	45
Precision	74	6.1	45

Notes: "Asia" includes India and Pakistan. Based on 1993 exchange rate of ¥115 = $1. "Share" is percentage of all cases in that manufacturing industry.
Source: Management and Coordination Agency, *Kagaku gijutsu kenkyū chōsa hōkoku*, 1994, p. 168.

Japanese banks have moved aggressively into the region to support these manufacturing operations. Asia is now home to scores of Japanese branch banks.[17] With its liberal banking regulations, Hong Kong has emerged as the financial center of Japan's budding production alliance in Asia. Japanese banks extend 60.7 percent of all the loans issued there, many of them to Japanese affiliates in Asia but outside Hong Kong.[18]

For our purposes, we must also pay careful attention to technology license agreements, franchise arrangements, and other "intermediate" forms of overseas business activity. Table 1.1 shows the rapid increase of Japanese technology exports to Asia from 1986 through 1993, while Table 1.2 presents a breakdown of such exports in 1993 by four manufacturing sectors. Because they do not generate the capital flows that characterize FDI, these forms of business activity often go unnoticed despite their crucial importance, especially in the case of Japanese investment in Asia. As a result, the actual scale of Japan's regional expansion is substantially understated.

We tried to compensate by reviewing and recomputing statistics compiled by Tōru Nakakita from the *Nihon keizai* newspaper's electronic data system between September 1985 and June 1988.[19] We found that intermediate or nonequity forms of overseas business activity accounted for about 40 percent of Japan's total activity in Asia. Lacking the capital to build their own overseas production facilities, it seems that small-scale manufacturers such as parts suppliers have come to rely heavily on technology agreements to extend their reach into Asia. This has been especially true in places such as South Korea where FDI has not always been so welcome. In the five years from 1978 through 1982, Japanese automobile parts manufacturers entered into only four technology agreements with their Korean counterparts; however, in the same length of time, from 1983 through 1987, they entered into 40.[20]

Today, Japanese parts drive Asia's machine industries. Without them, the region could not produce the televisions, CD players, personal computers, fax machines, and air conditioners that it exports in such huge quantities each year to North America and Europe. It is no wonder, then, that Asia's trade deficit with Japan is growing even faster than its trade surplus with the West. The NICs, the ASEAN-4, and, increasingly, China's coastal economy have become embraced by Japanese technology. Rather than autonomous agents, these economies are functioning more and more like subcontractors, or junior partners, in an export-oriented, *keiretsu*-like alliance dominated by Japan.

Some may find our argument ahistorical, and thus difficult to swallow. After all, hasn't the Japanese government in recent years lost the political power and regulatory tools to guide private investment? Haven't employees, witnesses to or victims of layoffs in the post-"bubble" recession, become less loyal to their employers? And haven't *keiretsu* ties loosened somewhat in the past decade? We readily acknowledge that Japan's political economy has changed as it has matured and responded to international criticism. At the same time, however, we contend that it has not changed as much as others have suggested. The bureaucracy continues to carry considerable clout as it collaborates with business on the formulation and execution of public policy, including foreign economic policy. Production supervisors still count on factory workers at home and in Asia to help them achieve productivity goals. And high-technology firms, including those operating in places such as Taiwan and Malaysia, continue to maintain close ties with long-standing suppliers and distributors. Japan's political economy has become regionalized far more than it has been revolutionized.

In the early 1990s, the post-bubble recession accompanied by higher interest rates at home stanched the flow of capital to developed regions such as the United States and Europe. But Japanese manufacturers, particularly machine makers, continued to invest heavily in Asia. In 1994, an estimated 44 percent of the total overseas production of Japanese electrical and electronic machine makers came from their increasingly busy affiliates in the region.[21] Japanese firms in Asia now produce 27 percent more televisions, VCRs, stereos, and other audio-visual equipment than their parent firms in Japan do.[22]

To be sure, these affiliates do their part to feed growing local markets. At the same time, though, they have come to view the region as "a production base to service the global market," according to the Research Institute for Overseas Investment.[23] Hitachi, for example, shut down its Anaheim, California plant and moved its production of VCRs for the US market to Malaysia.[24] Other big Japanese investors in the United States, such as Fujitsu General, scaled back their American operations at the same time that they beefed up activities in Southeast Asia.[25]

Thai officials reported that Japanese FDI jumped sharply in that country in 1993 and again in 1994 as electronics manufacturers such as Casio and Sony, as well as automakers such as Toyota and Honda, spent huge sums of money to expand production capacity. In fact, Japanese firms accounted for nearly 40 percent of all foreign investment proposals in Thailand in the first half of 1994.[26] The fast pace continued into 1995, when Toshiba, for example, announced that it would invest $120 million over three years to expand production at its seven plants in Thailand.[27]

Thailand was not the only target of this new, post-bubble round of investment. In just one year, 1994, Japanese manufacturers expected to invest as much money in the Philippines as they did in the last five years of the 1980s. And in the three years from 1992 through 1994, they planned to invest nearly three times as much in Indonesia as they did in the three years from 1987 through 1989. Sanyo Electric Co. was one of the biggest investors, pumping $34 million into a plant to manufacture refrigerators.[28] And in Malaysia and Singapore, officials reported a similar although less dramatic burst of activity by Japanese firms. Aiwa and Yamaha, two major audio manufacturers, were planning to spend more to increase production in Malaysia, while Giken Sakata, a manufacturer of precision parts for consumer electronic products, and Yamazaki Mazak, which produces machine tools, were hoping to do the same in Singapore.[29]

But for all its power to attract Japanese capital, Southeast Asia's magnetism has appeared almost anemic next to China's. The Middle

Kingdom was the target of 636 cases of FDI in 1994, making it the most popular destination in the world for Japanese investors.[30] Although small, labor-intensive firms are behind most of this activity, large high-tech firms are playing an important part. Canon, for example, has opened a plant to manufacture fax machines in China.[31] NEC has established a joint venture to produce computer peripherals.[32] Sony has invested millions in a new facility to produce camcorders.[33] Toyota, a step or two behind Suzuki, says it will try to assemble 150,000 cars a year in China beginning in 1996.[34] And Matsushita is planning to build eight new factories there.[35]

This massive flow of Japanese capital into Asia is no flash-in-the-pan event. It is at least a medium-term phenomenon. "Japan's main target must be Asia," says Hosoya Yūji, deputy director of MITI's industrial policy bureau.[36] Based on its own survey, the government predicted that, from 1994 through 1996, more than half of all Japanese FDI would go to Asia.[37]

We do not expect the North American Free Trade Agreement (NAFTA) to upset expectations by drawing an increasingly large amount of Japanese FDI into Mexico. Investors have been put off by the agreement's strict rules of origin, which require assemblers to use a high percentage of North American inputs, as well as by the ongoing political and economic turmoil in Mexico.[38] For such investors, Asia continues to be the best bet – far better than Europe or the United States, the other relatively popular destinations. In 1993, for example, affiliates in Asia earned profits of $3.3 billion, while those in Europe lost $357 million and those in North America lost $772 million.[39] Although aggregate data are not available, statistics for individual corporations suggest that Japanese affiliates in Asia continue to perform well. Honda's five affiliates in Thailand, for example, earned about $50 billion – approximately 20 percent of Honda's total corporate earnings – in the first half of fiscal 1994.[40]

Many Japanese MNCs are using their Asian profits to boost the capacity of their production networks. Because the official data maintained by bureaucrats in Tokyo do not reflect the value of such reinvestments, they substantially understate the total amount of Japanese FDI in Asia. In fact, some believe they understate it by as much as 40 percent.[41]

Consider the case of Matsushita. It beefed up its facilities in Asia by reinvesting about $100 million of the profits it earned in the region between 1989 and 1991.[42] And, on a smaller scale, consider the case of Mitsubishi Electric. Faced with another year of losses at home, it too moved to restructure its global operations, pumping more money and manpower into Asia. Nishina says the company decided to follow the advice of the Japanese government, which had been prodding high-technology manufacturers to consolidate and integrate their Asian facilities. But Mitsubishi Electric, he adds, also chose to use its own