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The Japanese Model in retrospective: Industrial Strategies, Corporate Japan and the ‘Hollowing out’ of Japanese industry

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Abstract

This paper provides a retrospective look at the Japanese model of industrial development. This model combined an institutional approach to production based around the Japanese Firm (Aoki's (1990), J-mode) and strategic state intervention in industry by the Japanese Ministry of International trade and Industry (MITI). For a long period, the alignment of state and corporate interests appeared to match the wider public interest as the Japanese economy prospered. However, since the early 1990s, the global ambitions of the corporate sector have contributed to a significant 'hollowing out' of Japan's industrial base. As the world today looks for a new direction in economic management, we suggest the Japanese model provides policy-makers with a salutary lesson in tying the wider public interest with those of the corporate sector.

Keywords: Corporate Japan, J-mode, Industrial policy, keiretsu networks, globalisation, hollowing out.

1. Introduction

Over the years, Asia has provided a rich source of industrial strategies for economic development, particularly those which have involved partnerships between business and the state. The most influential of these industrial strategies was the Japanese model of industrial development, versions of which were later adopted in other Asian countries (most notably South Korea). The model itself primarily consisted of i). a unique *institutional* (production) system based around the Japanese Firm (Aoki's (1990) so-called 'J-mode') and (small firm) co-operative networks known as the '*keiretsu*' and ii). an *interventionist* industrial policy that nurtured and supported selected strategic industries (Johnson, 1982, 1986). Between 1945 and 1989, this combination delivered as Japan and Japanese businesses outperformed their international rivals – on almost all economic measures - with the country itself emerging as the world's second largest economy (see Graham and Seddon, 1990).

The success of the Japanese model was - from the 1970s onwards - widely lauded by both management writers and policy commentators and subsequently promoted as an alternative (third way) to Anglo-US neo-liberalism (and Soviet communism). It was seen as a progressive form of capitalism or 'alliance capitalism' (Gerlach, 1992), one which was more inclusive and involved wider stakeholders in both business and economic management. Indeed, there appeared a particular congruence between state intervention and the growth of large Japanese businesses and this consensus appeared to serve the Japanese public interest: for instance, the growth maximising behaviour of Japanese corporations and their preference for internal growth over acquisitions appeared to provide wider opportunities for Japanese employee involvement (Odagiri, 1992), while the emergence of successful Japanese corporations – that had once been

nurtured and supported by the Japanese state - on the global stage gave the country rising international prominence and economic status (see also Kenny and Florida, 1988, 1993).

However, over the last twenty years, many commentators have subsequently retracted their previous endorsements as the Japanese economy endured ongoing economic stagnation with its manufacturing sector – once the source of its economic strength - in particular, suffering from ‘hollowing out’ largely due to its giant corporations seeking new overseas pastures (Cowling and Tomlinson, 2000). Indeed, in trying to explain (and in seeking to resolve) Japan’s economic woes, analysts have sought to blame over-regulation, interventionist industrial policies and ‘antiquated’ financial and industrial institutions, all of which were once integral to the country’s earlier success. For instance, Japanese employment practices have been regarded as being a barrier to generating new business, while the nature of Japan’s industrial groupings – *the keiretsu* - were blamed for ‘excessive investment’ and poor returns to capital. Moreover, Western commentators have continually argued that Japan undertake major structural reforms and move towards the Anglo-US neo-liberal model of capitalism (see, for instance, Katz, 1998, Porter, et.al, 2000). And indeed, the Japanese state has recently moved towards a less interventionist stance, while Japanese businesses have begun the process of re-structuring their operations along Anglo-US lines: see, for example, the recent discussion by McGuire and Dow (2009) on changes in *keiretsu* ties, and also Tett (2004) for an application of US management styles in Japanese banking.

Recent events in the world economy however - particularly in relation to rising concerns about the prominent role afforded to the corporate sector – suggest that the (neo-liberal) Anglo-US hegemony in economic management might well be over and there have been calls for both policy-makers and business leaders to adopt a new global approach to business and economic management¹. This might suggest that (further) moves by Japan towards Anglo/US neo-liberalism are probably misguided and in retrospect, it might therefore now be poignant to take a fresh look at the Japanese model². Intriguingly, when one does so it becomes apparent that there are remarkable similarities in the (long run) failures in both the Anglo-US and the Japanese economies and which are largely related to the dominant role played in the countries' development by the giant corporations.

This paper explores this argument in further detail through a retrospective review of the Japanese model, in particular its industrial organisation and industrial policy. In doing so, we adopt the strategic decision-making approach to industrial organisation, which emphasises the importance of (wide) participation in decisions over key (economic) variables (such as investment, employment and output) for the determination of development paths of industries and economies. In situations where strategic decision-making is concentrated among a few actors (a corporate hierarchy), the danger of 'strategic failure' arises: a situation where the strategic decisions of the corporate hierarchy fail to satisfy the wider public interest, with no market mechanism available to reverse the process (Cowling and Sugden, 1998). In the case of Japan, the

¹ Indeed, during the recent G20 summit in London in April 2009, Gordon Brown, the UK Prime Minister, called for a new global approach to economic management from both policy-makers and business leaders (The Guardian, 10/4/09). The election of the Obama administration in the USA has also signalled that a new economic direction (i.e. away from neo-liberalism) is required.

² More generally, in searching for new (alternative) development paths, a sense of historical perspective is required and it is perhaps important for policy makers and business leaders to learn from previous experiences of development strategies such as those employed by Japan.

growth in the economic power of its giant transnational corporations led to a significant ‘hollowing out’ of its industrial base with adverse consequences for its economy (and lessons for public policy) and we would construe this as a ‘strategic failure’.

The remainder of this paper is set out as follows. We begin our analysis by with a re-appraisal of the literature on the Japanese corporation (the J-mode (Section 2)). This is important since the J-mode was often purported to be a significantly different entity than its Western counterpart, and is often regarded as the main source of Japan’s post-war competitive advantage (see Aoki, 1990). Section (3) reconsiders the role of industrial policy and explores the growth of corporate Japan and its role shaping the country’s economic development. Section (4) identifies the roots of Japan’s industrial stagnation and presents some evidence on the ‘hollowing out’ of Japanese manufacturing. Although our prime focus is upon the industrial sector, we argue that much of our analysis explains Japan’s wider malaise over the last twenty years. Finally, Section (5) concludes.

2. The Japanese corporation (the J-mode)

In analysing the earlier success and recent failures of the Japanese economy, it is instructive to begin with an understanding of the Japanese corporation. The reasoning is twofold. First the giant corporations play an important part in the economic system as a whole and ascertaining their role in the process is crucial in tracing the development path of the economy (Chandler, 1962, Teece, 1993). Secondly, and particularly pertinent in the Japanese case, we follow Aoki (1990: 2) who remarked that ‘one of the important sources of the industrial strength (and weaknesses in certain

respects) of the Japanese economy can be found in the micro-micro (internal) structure of firms'. Indeed, in a number of influential articles and books, Aoki (1984, 1988, 1989, 1990, 1994) sought to portray the Japanese firm – the so-called J mode – as a unique entity, one that is distinctly 'less hierarchical' in its organisation and outlook than its Anglo-American counterpart (which Aoki describes as being 'hierarchical' and subsequently labels the 'H-mode')³. The main differences between the J-mode and the H-mode refer to the management of production activities, employer-labour relations and finance and equity arrangements.

For instance, in the literature, the traditional large Western corporation (the H-mode) has been typically characterised as a multi-divisional, vertically integrated firm which strove for internal efficiencies and economies of scale through the standardisation of its (mass produced) products and division of its labour force (Radner, 1992, Teece, 1993). It also had a hierarchical management structure, which acted as both an incentive device for workers by offering promotion opportunities and as a means to control indiscipline (Aoki, 1990, Ruigrok and Van Tulder, 1995). However, while it was able to achieve internal efficiencies, the H-mode's Achilles' heel was that it often appeared inflexible in adapting to changing demand patterns and difficult economic conditions (Piore and Sabel 1984). In contrast, Japanese firms were seen as being more flexible in production, resilient and successful in the face of international crises (Kenny and Florida 1988, 1993).

One of the main sources of this strength was the close co-operative ties that exist between Japanese firms, whether in horizontal corporate groupings - the so-called

³ The Japanese Firm continues to attract interest and attention among scholars – see, for instance, Jackson (2009).

‘kigyo shudan’ (Scher, 1997) – with its main bank system, which provided firms with access to cheap funds and assistance in financial and foreign markets and occasionally undertook industrial rescues (Aoki and Patrick, 1994, Hoshi and Kashyap, 2001), or through the vertical *keiretsu* networks, Japan’s revered subcontracting system. In the latter respect, the *keiretsu* have received much attention in the literature (see McGuire and Dow, 2009), with significant emphasis being placed upon the mutual financial commitments, technology and personnel exchanges and the relatively (free) sharing of information between partner firms. The prevalence of cross-shareholdings between partner firms also encouraged stability in equity holdings, shielding firms from the short-term threat of takeover and thus helping facilitate (J-mode) commitments to long-term investment decisions (Sheard, 1994). The general consensus that emerged was that the J-mode was unique in establishing and sustaining such long-standing inter and intra firm ‘close ties’ and ‘mutual trust’ (see, for instance, Gerlach, 1992, Smitka, 1991). Moreover within the J-mode, there were also significant differences that were seen as enhancing efficiency and labour productivity. The emphasis in the J-mode was upon job rotation and variety in tasks, providing for a more highly skilled and dexterous workforce, with financial rewards linked to service and performance in a rank hierarchy⁴. Aoki (1990) also argues that the working environment within the J-mode allows for wider information sharing between employees across departments (thus promoting positive learning externalities) and for a greater delegation of decision-making throughout the organisation (which might be deemed as being more inclusive). In contrast, the ‘H-mode’ was epitomised as one where personnel status matters, and is supported by layers of specific tasks being created. This was regarded

⁴ Rewarding workers in this way is seen as enabling J-mode firms to retain employees with firm specific skills, thus helping to explain the long-standing tenure of Japanese employment. This is contrasted to the H-mode, where promotion incentives generally lead to a removal of skills from the shop-floor (Aoki, 1990).

as leading to inflexibility in worker skill levels and reluctance among (Western) managers to delegate decision-making since it might undermines their authority.

For writers such as Aoki and others, the J-mode underpinned the Japanese economy: the ‘flexibility’ and ‘non-hierarchical’ modes employed by Japanese corporations being seen as the source of Japan’s competitive advantage and (earlier) economic success. However, a close inspection of Aoki’s J-mode reveals some remarkable similarities in its command and control structures with those one generally associates with Western corporations. Let us first briefly re-consider the J-mode’s management of the *keiretsu* networks. As mentioned above, the nature of these relationships in what appears as a vertically de-integrated industrial structure, is often portrayed as being markedly different from that observed in the West (see also Womack et.al (1990)) and such commentaries in the management literature have provided the basis for Aoki’s (1990) claim that the J-mode is ‘non-hierarchical’ in production. However, this depiction of the J-mode is potentially misleading, particularly when one considers the well-documented evidence that Japan’s giant corporations often exercise considerable control over their smaller *keiretsu* partners.

For instance, consider the automobile industry, which has the largest and widest set of *keiretsu* networks in Japan and is used as the reference point for Aoki’s thesis. The first point to note here is that at the pinnacle of the industry’s hierarchy the giant Japanese assemblers typically hold significant equity stakes in both their core and - along with their major *keiretsu* partners - lower tier suppliers⁵. These equity holdings

⁵ This issue – along with relevant data - is explored in further detail by Coffey and Tomlinson (2003a: 125-132). Drawing upon earlier work by Cusumano (1985), they argue that if one considers an assembler’s controlling equity stake in a supplier to be 20% (as suggested by Berle and Means, 1932), rather than the standard 50% ownership threshold, then it could be construed that the degree of vertical

have allowed the giant assemblers to place former senior employees into key positions throughout the supply chain, a move that establishes direct lines of communication and facilitates the dissemination of corporate strategy – from the assemblers’ hierarchies - throughout the production and supply chain. Yet, while equity holdings have undoubtedly provided assemblers with direct control over their lower tier partners, due account should also be paid to other control levers that are perhaps less obvious but are exercised outside the corporation’s legal boundaries and through the locus of its strategic decision making. These are considered in some detail by Ruigrok and Van Tulder (1995: 51-54) and include the subjugation of *keiretsu* partners by assemblers dictating contract conditions and imposing technologies and processes upon them. Moreover, Japanese assemblers are extensively engaged in the multiple sourcing of components, which places their smaller *keiretsu* partners - three-quarters of whom typically depend upon one assembler for over 50% of their orders (Dodwell, 1997: 11) – in a significantly weaker bargaining position in contract negotiations⁶. Indeed, the transactional hierarchy of the Japanese automobile industry has led Ruigrok and Van Tulder (1995: 53) to describe the situation as one where there is ‘a one-way dependency of suppliers on the end producers’. Similar sentiments have also been expressed by industry practitioners⁷.

integration in the Japanese automobile industry is actually higher than that recorded in the North American assemblers.

⁶ Indeed, it is worth noting that Japanese assemblers rely upon multiple-sourcing of production to a far greater extent than their North American competitors. For instance, Womack et.al (1990, p.157) report that for Japan just over 12% of parts were single sourced by assemblers compared to almost 70% in the USA – this refers to the situation for first tier suppliers, although it is recognised that multiple sourcing is also the norm further down the chain.

⁷ For instance, Adio Kodani, a former Nissan-appointed President of the Nissan-affiliated supplier Ikeda Bussan, notes that ‘the keiretsu served to create a comfortable vertical supply structure for Nissan, rather than as a structure to make affiliates stronger’ (Nikkei Weekly, 21st August 2000). A similar perspective is offered by Kono (1984: 127) who remarks that the keiretsu supplier ‘perceives that Toyota’s policy is ‘not to kill, neither to keep alive easily’’. Lincoln and Gerlach (2004) have recently expressed similar concerns in relation to vertical *keiretsu*.

If the reality of the J-mode's external relations is that they do not fit Aoki's 'non-hierarchy' thesis then what about internal relationships? Recall that the J-mode was posited as providing workers with greater autonomy (and inclusivity) within the working environment. Indeed, the arrangements within Japanese corporations led some writers to argue that they favour employees, who could be considered as the J-mode's most important stakeholders (see Abegglen & Stalk, 1985; Miwa, 1996). However, this would be an erroneous interpretation. It is our contention that strategic decision-making processes within corporations (i.e. those which determine the direction of the company), whether they be Western or Japanese, are not widely dispersed but rather are and always have been concentrated within the corporate hierarchy⁸. In this regard, references in the literature to a decentralisation of decision-making within the J-mode typically refer to operational decision-making which affect the day to day running of the firm as opposed to those decisions that govern its strategic orientation. This point also appears to be accepted by Aoki (1990: 13-16) who is quite clear in this respect that workers are subordinate to management authority (who are in turn monitored and are answerable to the major shareholders). Indeed, if we also consider the lack of a veto by Japanese workers (or their representatives) on the recent globalisation activities of Japan's giant corporations, which have worsened employment prospects in Japan (see Section 4), then it is apparent that the J-mode's main stakeholders are its corporate hierarchy and not its workers⁹.

⁸ In terms of Japanese corporations, analysis by Sheard (1994: 310) suggests that the major equity holdings are concentrated among a few shareholders who exercise joint control (which is similar to Western corporations).

⁹ We might also point out that, in terms of employment conditions, the benefits and privileges afforded to Japanese workers have tended to be only available to those in the leading firms: those employed in lower tier subcontractors are excluded and typically endure worse employment conditions (see Ruigrok and Van Tulder, 1995: 25 and also 46-51). Moreover, in the automobile industry, Womack et.al (1990: 158-159) applaud the use of Japanese assemblers using multiple sourcing strategies to mitigate the

We could elaborate much further upon these and other points regarding Aoki's J-mode and its perceived differences with its Western counterpart: a full critique of the J-mode is provided by Coffey and Tomlinson (2003a and b). What is clear is that Aoki's description of the J-mode as a 'non-hierarchical' entity is questionable and that the reality is that governance systems within the so-called J-mode are quite similar to those that exist in its Western counterpart – in essence, control is exercised by a corporate hierarchy from a centre of strategic decision making. Moreover, the concentration of economic power within corporate Japan has had significant implications for the direction and the performance of Japan's manufacturing sectors particularly over the last two decades. We will now take up this point in Sections (3) and (4).

3. Industrial policy, Corporate Japan and Globalisation

The other main facet in Japan's post-World War II economic development path was the role played by the Japanese Ministry for International Trade and Industry (MITI) (see Johnson 1982, 1986)¹⁰. During the post-war era, MITI was proactive in strategically planning and nurturing a market economy: this provided the basis for Johnson's (ibid) 'developmental state'. This included selecting and promoting industries that were identified as being 'strategic' from the perspective of the national economy: in the 1950s and 1960s these comprised of the heavy industries (iron and steel, shipbuilding and electric power), in the 1970s and 1980s, consumer durables (automobiles and semi conductors) and in the 1990s, the higher technology sector

threat of trade union militancy: a strategy that suppresses the ability of workers to bargain effectively for better employment conditions (see also footnote 14).

¹⁰ For a recent review of Japanese political economy and economic growth before World War II, see Grabowski (2007).

(advanced electronics and computer research). A range of policy measures were introduced, including the regulation of foreign trade to protect domestic ‘infant industries’ and the provision of export subsidies. MITI also encouraged the importation of foreign technology, but this was closely regulated along with both inward and outward foreign direct investment (FDI). The strict FDI regulations reflected MITI’s concerns that (1) US led transnationals would enter and dominate Japan’s domestic markets at the expense of nationally owned companies and (2) outward FDI and offshore production would encourage ‘reverse exports’ and harm Japanese domestic industry (Bailey et.al 1994). Through pursuing an interventionist industrial policy, Japan was able to quickly overcome the devastation left by World War II, out-perform her main international and by the early 1980s, emerge to become – in terms of GDP – the world’s second largest economy (Graham & Seldon, 1990).

For Johnson, Japan’s ‘economic miracle’ was a testament to the country’s institutions and the role afforded to state strategic planning in a market economy. Yet, while MITI’s industrial strategy might have initially reflected the public interest, over time it became more closely aligned with the interests of Japan’s corporate sector. Indeed, Piore and Sabel’s (1984) observed that MITI’s policies contained a clear prejudice in favour of promoting its giant corporations, often at the expense of the smaller *keiretsu* firms: industrial strategy being based upon the *keiretsu* being subservient to the strategic interests of the giant corporations (see Section 2)¹¹. MITI also approved a programme of cartelisation, which further raised the level of industrial concentration and reduced domestic competition within the economy (see Schaeede, 2000). Bailey

¹¹ On this, it is also worth considering Ruigrok and Tate’s (1996) account of activities within MITI’s publicly funded testing and research centres for small firms in the automotive industry. The authors reveal that these centres ultimately became the preserve of Japan’s giant assemblers and a mechanism by which to exert further control over their suppliers.

(2003a) has also noted that changes to Japan's Commerce Laws in the 1960s led to an increase in the concentration of shareholders within Japan's corporate groups and the continued dominance of the horizontal 'kigyo shudan'. Moreover, corporate Japan developed and maintained close links with MITI to the extent that it was able to influence the higher echelons within the ministry, often being successful in lobbying for changes in national policy to pursue its own strategic interests (see for example, Johnson, *ibid*, 68-74). This influence was particularly apparent in MITI's concession to eventually relax the restrictions on outward FDI in 1971 (Mason, 1994: 21-25). While one might expect such restrictions to be lifted as an economy evolves, the timing and sequencing of this de-regulation process appeared to specifically benefit those industrial sectors in which the large Japanese corporations were dominant, at the expense of utilising policy changes to ensure a more even balance in the performance of Japan's export orientated industries and the more domestic focused service sectors (Bailey, 2003b). In short, Japanese industrial policy was ultimately geared towards the promotion of Japan's corporate giants – its 'national champions' – who were increasingly encouraged to compete internationally with their rivals from the USA and Europe.

Since the early 1970s, corporate Japan has expanded its interests throughout the globe. The lifting of the FDI restrictions provided the catalyst for Japan's transnationals to increasingly shift its production activities offshore in order to enhance their bargaining power with labour and take subsequent advantage of lower labour costs, to overcome rising trade barriers and to compete strategically with their domestic and global rivals¹². This overseas expansion was particularly prominent

¹² The nature of competition has predominantly been one of regional and global oligopolistic

during Japan's halcyon years of the 1980s and continued until well into the mid-1990s: for instance, between 1981 and 1995, Japanese FDI amounted to over \$470 billion, representing a fourfold increase (in real terms) over the period and the highest average growth rate (22%) in overseas investment of any G8 industrial nation (UNCTAD, 1997). And while the growth rate in Japanese FDI has since fallen slightly, corporate Japan has continued to pursue an internationalisation strategy. This increasing internationalisation of Japanese industry is perhaps best reflected in the continued growth of Japan's overseas production ratio. This ratio measures the proportion of total (Japanese) manufacturing output produced offshore¹³: in 1985 it was 3% of domestic output, by 2006 it had risen six-fold to 18.2%. Furthermore, in 2006, Japan's transnationals produced 31.4% of their total output overseas, again up from 8.7% in 1985. In 2006, Japan's transnationals directly employed approximately 4.56 million foreign employees - up from just over 1.1 million in 1992 - in their offshore affiliates around the globe (all data from METI, 2008; Ito, 2003).

The reported data is indicative of the growing extent to which Japan's corporate giants have become involved in transnational production networks – sometimes referred to as the *new (overseas) keiretsu*. These networks primarily involve production linkages across the economies of Asia, North America and Europe through

interdependence and it is interesting to note in this regard the behaviour of Japanese corporations in so much as - like their Western rivals - they have strategically undertaken both 'aggressive' and 'defensive' investments to expand and protect their local, regional and (ultimately) global market share. Some evidence of this so-called Knickerbocker (1973) effect for Japanese corporations is provided by Yu and Ito (1988), in the case of Japanese investments in the US tyre and textile industries, Dunning (1994) for the entry of Japanese machinery firms in Europe and Tomlinson (2005) for the global entry patterns of Japanese automotive corporations.

¹³ The overseas production ratio (as with the overseas investment ratio discussed in Section 5) is calculated using data from METI's annual survey of Japanese transnationals. Given that these surveys are typically vulnerable to variance in coverage and response rates, it is wise to treat such statistics with caution (Ramstetter, 1996). Nevertheless, in the absence of alternative data sources, and taken in conjunction with the other evidence presented here, the overseas production ratio, is a useful indicator of the internationalisation of the Japanese economy.

the operations of Japanese affiliated and group companies. It is through these networks that Japan's corporations have been use the credible threat of relocation to exercise a 'divide and rule' strategy vis-à-vis world governments (in pursuit of favourable tax regimes, subsidies and/or favourable regulatory environments) their international workforce and supply chain (placing downward pressure upon wage and supplier costs)¹⁴. Moreover, the global expansion of corporate Japan has – as we shall argue – not only been detrimental for the performance of Japan's domestic welfare, but it has nullified the ability of MITI and the Japanese state to successfully manage the direction of the Japanese economy.

4. The 'Hollowing out' of Japanese manufacturing

The first consequence of the globalisation of Japanese industry relates to the diversion of investment away from Japan's industrial regions in favour of overseas locations, thus reducing the future potential for indigenous growth within Japan. Given that corporate Japan now takes a global view in allocating its limited investment expenditures, this is likely to be significant. These investment funds are limited in supply since the majority of Japanese corporations have tended to rely upon net earnings as the major source of net finance for new industrial investment (Corbett and Jenkinson, 1996; Yaginuma, 1997). Moreover, with imperfect capital markets, transnational firms are likely to distribute their internally generated funds between competing international locations (Stevens and Lipsey, 1992). In this respect, cost considerations are likely to be a key determinant and the evidence suggests that this is

¹⁴ A case in point was Toyota's ability – in the late 1990s - to successfully play-off both the UK and French governments in the pursuit of a 'lucrative' investment package for their new European production site (which was eventually built in Lens, Northern France). As far as bargaining relations with workers is concerned, James (1989) notes that by locating new production units in areas characterised by low trade union density, low wages and high unemployment, Japanese transnationals have successfully been able to play the 'international wage game'. For further evidence on this is provided in Coffey and Tomlinson (2003b: 13-14).

indeed the case. For instance, in Japan's highly important machinery sector, the behaviour of domestic investment (and employment) is highly sensitive to international wage differentials: both domestic investment and employment functions being relatively elastic with respect to variations in international wages (Tomlinson, 2002). Concerns were also raised during the mid-1990s that a substantial number of Japanese firms had been investing in low cost offshore facilities in East Asia at the expense of domestic sites (MITI 1996). This situation has continued with China - where wage costs are approximately 1/30th of those for comparable employment in Japan (Kobayashi, 2004) - becoming the main substitute for Japanese investment in Asia (JETRO, 2004). In summary, for corporate Japan, overseas investment opportunities have become increasingly more attractive than in Japan as reflected in the ever rising overseas investment ratio (the proportion of Japanese capital invested annually overseas): 8.8% in 1992, and up to 20% in 2001 (METI, 2003).

In the long run, the diversion of investment in favour of cheaper overseas sites diminishes both the level and quality of Japan's capital stock, and thus initiates and exacerbates a cumulative process of decline in Japan's industrial regions¹⁵. The growing evidence is that corporate Japan's overseas investments are primarily a substitute for domestic production rather than to support complementary production activities. A consequence of this has been the dramatic decline in employment within Japan's domestic manufacturing industry over the past decade, with registered manufacturing employment falling from 15.69 million in 1992 to 12.22 million in 2003. Ito (2003) reports that an estimated 600,000 of the decline in Japan's domestic

¹⁵Given the discrepancy in the outward to inward stock of Japanese FDI of 12:1, it is unlikely that any inward investment flows will reverse the process. Moreover, inward FDI might even exacerbate deindustrialisation in Japan. For instance, Renault's purchase of a controlling interest in Nissan and General Motors' increased equity participation in Isuzu led to automobile plant closures and substantial redundancies in Japan's major industrial belts.

manufacturing employment during the 1990s was a direct result of global outsourcing: his estimate takes account of the (positive) export induction effect (sales of capital and intermediate goods from Japan to overseas affiliates) and the (negative) export substitution (where overseas production replaces exports) and re-importation effects (goods produced by overseas Japanese affiliates and re-imported into Japan)¹⁶.¹⁷ The largest declines in domestic employment were in the machinery sector – in which Japan has long held a comparative advantage - which has seen the greatest expansion in overseas production (Ito, *ibid*).

A further consideration has been the effects of globalisation upon Japan's small firm sector, particularly the small *keiretsu* firms who have become increasingly isolated and placed in a weaker bargaining position as their main contractors have resorted to the global outsourcing of intermediate goods and services. Indeed, since the early 1990s, surveys have consistently shown that these small firms have experienced a significant fall in their order book volumes and been under pressure to accept lower profit margins making it difficult for them to earn sufficient revenue to repay long term borrowing commitments (see for instance, MITI, 1998, 1999). These pressures are reflected in small firm gross profit margins in Japanese manufacturing, which have fallen from an average of 3.5% in the late 1980s (1986-1991) to zero in the period 1999-2004, while the return on capital employed has more than halved from an average of 5.6% to 2.2% over the same time-frame. A further indicator of the pressures afflicting Japanese small businesses are the number of small firm bankruptcies, which have continued to be extraordinarily high – averaging around

¹⁶ According to METI (2003), 85% of re-imports are from low cost Japanese affiliates based in East Asia.

¹⁷ If we also consider the indirect effects of global outsourcing, the loss of jobs in Japanese manufacturing due overseas expansion is likely to be much greater than 600,000.

17,000 for three years to 2003 (data obtained from the Japanese Statistical Yearbook, 2005). Moreover, since the early 1990s, the exit rate of firms in Japanese manufacturing has significantly exceeded the number of business start-ups. For Aicht et.al (2004: 14) the increasing closure rate is a result of industrial restructuring and ‘hollowing out’ and, in discussing the prospects for entrepreneurship in the Japanese economy (where, in contrast to most other OECD countries, business ownership rates have been in long term decline) they worryingly note ‘the safe haven for small firms has disappeared and it has not been adequately replaced with an alternative institutional structure stimulating new venture creation’¹⁸.

The problems afflicting the *keiretsu* and the ‘hollowing out’ of Japanese manufacturing have been widespread across Japan: since the early 1990s, all prefectures and industrial sectors experienced a significant decline in real output, business activity and employment. The large industrial belts of Kanagawa, Tokyo, Osaka and Saitama, regions that have traditionally relied upon corporate Japan for their economic prosperity have, not surprisingly, been particularly adversely affected. The industrial capacity of these regions fell dramatically throughout the 1990s, and they continued to experience higher levels of unemployment than the national average (for further details and data on these and other regions, see Cowling and Tomlinson, 2003a). It is our view that the problems of deindustrialisation in Japan’s industrial regions significantly weaken the country’s prospects for long term economic recovery and renewal – the decline in small firm activity and entrepreneurship along with the actual and potential loss of ‘vitality’ and ‘innovative’ capacity within small firm

¹⁸ The ‘safe haven’ here refers to the traditional *keiretsu structure* which, although highly exploitive (see Section 2), at least to some extent provided - for the majority of sub-contractors - a minimum guaranteed income stream.

networks being particularly detrimental to future economic growth (see also Acht et.al, *ibid*).

The 'hollowing out' of Japanese industry has occurred despite Ozawa's (1991, 1992) optimism that the internationalisation of Japanese industry would be an opportunity for Japanese industry to restructure and upgrade its manufacturing technology through the redeployment of resources into the development of higher value added products, with traditional, declining industries being moved offshore. Ozawa envisaged that this would lead to a 'flying geese formation' of production, where advanced technological work was completed in Japan, medium value added work is done in the newly industrialised economies (NIEs) and so on throughout Asia - the benefits of this pattern being seen as a combination of rising technological standards and the extension of product life-cycles beyond Japanese and Western markets (see also, Blomqvist, 1996). Unfortunately, for Japanese manufacturing, this does not appear to have been borne out by events. As we have argued, corporate Japan has pursued its own strategic interests, and its offshore affiliates have been increasingly used as a direct substitute for domestic production and, in some cases, product development. In the latter case, it is interesting to note Beamish et. al (1997: 26) who reported a notable change in the strategy of Japan's transnationals, from establishing offshore 'assembly (plants), using parts sourced in Japan, to full manufacturing, to, in some cases, R&D located in the host country'. A similar point was also made by Whittaker (1997) who noted that, in production, it only takes a matter of months before the latest Japanese designed, sophisticated products are able to be manufactured offshore, in East Asia, to serve both Japanese and Western markets. In short, the purported benefits of the internationalisation of Japanese industry have not been realised.

5. Concluding Comments

As the world economy looks for a new direction in economic management, the Japanese model provides us with a salutary lesson in the alignment of state and corporate interests. Large corporations have long played the key role in the development path of economies, particularly in the industrialised world often shaping industrial structures to meet their own strategic interests. In the short run, corporate objectives may well be compatible with a country's economic development; in the long run, the ambitions of the corporate sector are unlikely to meet the wider public interest. In the case of Japan, over time MITI's ability to influence the direction of industry in the public interest diminished, with economic power effectively being acceded to Japan's giant corporations. These corporations shaped the country's industrial structure and economic development to suit their own strategic interests with production being organised – contrary to popular perceptions in the management literature – along hierarchical lines and control (within the Japanese corporation) being exercised by the corporate group of strategic decision makers. This corporate hierarchy has for some time now, pursued a strategy of global expansionism, developing and extending its own transnational production networks, to the extent that such activities have contributed to a significant 'hollowing out' of Japan's industrial base, with adverse consequences for its employees, smaller keiretsu firms and regional prosperity.

At a fundamental level, the challenge for Japanese policy-makers and industrial strategists (and elsewhere) in the twenty-first century is to seek new ways to achieve long term sustainable development paths. It is beyond the scope of this paper to explore these possibilities in great detail, but we would favour policies that aim to

diffuse the concentration of economic management (and strategic decision making) away from the corporate hierarchies and move towards more non-hierarchical modes of production. In this respect, one possibility might be to consider revisiting industrial strategies based upon models of local and regional development, with a specific focus upon strengthening Japan's small firm base and in particular, ensuring its' independence from the ambit of Japan's corporate sector. For its sustainability, we might envisage the evolution of horizontal small and medium sized firm networks with appropriate regional and institutional support mechanisms, perhaps along the lines espoused in the rich literature on industrial districts (Piore and Sabel, 1984, Becattini, 1990). Best (1990, 2001) has described such small-scale (co-operative) networks as a form of 'collective entrepreneurialism' and has highlighted their flexibility and diversity in being able to deliver sustainable regional prosperity in the face of challenging economic climates. For Japan (and indeed other countries), exploring such a possibility may offer the chance to transform the economy and allow the country to move towards a more diffuse, stable and sustainable development path.

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