

## Japan's Deformed Dual Economy

### The Two Japans

Nowhere do we see more sharply the obsolete and self-defeating nature of the Japanese system—and what happens when countervailing institutions are missing—than in the field of international trade. Japan remains entangled in a thicket of informal barriers that keeps imports, indeed overall trade, inordinately low. The result is a deformed “dual economy” unique in the industrial world. The secret of the economy’s tribulations is that there is not one Japan, but two.

The bright side of Japan’s economy is its exporting sector—industries like autos, consumer electronics, semiconductors, and machinery. This is the Japan that Americans see. Almost all the images of a rich, powerful, efficient Japan stem from these exporting industries.

In most cases, these export stars owe their initial takeoff to the “developmentalist” policies applied in the 1950s-60s. For example, an initially uncompetitive auto industry was rescued from oblivion by aggressive protection against cheaper European imports. Until the early 1960s, anyone wishing to import had to seek foreign exchange from MITI. In the case of autos, MITI refused to grant foreign currency for any imports beyond minimal quotas until 1965 when the industry was competitive on world markets. Even then, the quota was replaced by a prohibitive tariff. Similarly, the TV industry was not only given import protection, but it operated both legal and illegal cartels in which the industry charged high prices at home to subsidize lower-priced exports.

As these industries became export superstars, they drove the rapid industrialization of the rest of the economy. This success is what gave Japanese neomercantilism its legendary reputation.

But what the Old Guard in Japan and its U.S. admirers forget is that—as we’ll detail in Chapter 6—promotion and protection succeeded only when used for genuine infant industries. That is, industries which had the



Table 2.1

## Japanese Output per Hour by Industry Compared to the U.S. (U.S. = 100)

|                                     | 1950 | 1965 | 1973 | 1979 | 1990 | % of<br>1992<br>Mfg. Germany<br>Jobs 1990 |
|-------------------------------------|------|------|------|------|------|---|
| Machinery and equipment             | 8    | 24   | 51   | 80   | 114  | 39  |
| Basic and fabricated metal products | 13   | 23   | 61   | 84   | 96   | 12  |
| Chemicals and allied products       | 13   | 32   | 60   | 78   | 84   | 5   |
| Other manufacturing                 | 10   | 20   | 34   | 40   | 55   | 24  |
| Textiles, apparel and leather       | 25   | 38   | 53   | 55   | 48   | 10  |
| Food, beverages and tobacco         | 27   | 26   | 40   | 40   | 37   | 11  |
| Total manufacturing                 | 17   | 27   | 49   | 63   | 78   | 100                                       |

Source: van Ark (1995), pp. 56-73

intrinsic potential to become self-sufficient exporters, but which had not yet gained the economies of scale or learning-by-doing efficiencies to be competitive. They needed an initial jump-start.

Precisely because these exporters faced international competition, they could not permanently rest on government aid. They either had to hone their competitive edge or die. And so, they did. In many of these exporting sectors, Japan leads the world in productivity and technology (e.g., see machinery in Table 2.1). Japanese labor productivity is 24 percent ahead of the U.S. in automaking, and 15 percent ahead in consumer electronics. Japanese firms have often been the first in the world to introduce new products, from VCRs to oil supertankers, or to apply new processes, from solid-state TV to the continuous casting of steel.

Unfortunately, most Japanese live and work in quite another Japan—a Japan that neither exports nor imports and is therefore unknown to most Americans. This Japan is the product of the dark side of Japanese neomercantilism, the side that increasingly dominated in the 1970s and 1980s.

As Japan matured, it naturally ran out of “infant industries.” Protection was now superfluous and should have been abandoned. But Tokyo nonetheless applied a whole new round of widespread protection.

The initial impetus for the new protectionism was the deep industrial slump that followed the 1973 oil shock. Growth halved. Once-prosperous industries were suddenly plagued by chronic excess capacity. For many, this was not just a temporary shock. Aluminum, petrochemicals,

shipbuilding, textiles, basic steel, and many others were now permanently priced out of the market: not just by the oil shock, but by the rise of the Asian NICs, the elevation of Japanese wages, and other fundamental trends. The troubled industries accounted for at least half of Japan's manufacturing output, and a third of its factory workers.

Unwilling or unable to endure the pain of downsizing, companies and workers cried out. And the bureaucracy, often spurred on by the Liberal-Democratic Party *zoku* (caucuses), granted them relief. After all, the ruling Liberal-Democratic Party (LDP) depended for money and votes on some of the sectors that would be most hurt by the economic shakeup. And so, industrial policy degenerated into little more than political pork barreling and logrolling.

All of this belies the myth that, at the heart of the “Japanese economic model,” lies a bureaucracy that is immune to political pressure and therefore free to make decisions in the national interest. Now, it is certainly true that many industrial policy decisions were based on Japan's genuine economic needs. But, it is equally true that ministries are often captives of the industries they are supposedly guiding.

A classic case involves the years of struggle by former MITI official Morihisa Naito to end restrictions on gasoline imports as well as the ban on self-service gas stations. Success finally came in 1996-1998. The restrictions had subsidized Japan's notoriously inefficient refiners, led to rampant price-fixing, and provided a cushion for 60,000 gas stations, twice what a free market would support. When word of Naito's efforts got out, gas station owners distributed a “Wanted” poster with his photo. Meanwhile, his colleagues at MITI accosted him, demanding to know why he was jeopardizing their future job prospects. Like most officials in Japan, these bureaucrats expected to retire in their mid-50s and get a cushy position at the very companies they are overseeing. No wonder they didn't want any feathers ruffled.

Multiply such stories hundreds of times and one can easily see why so many moribund sectors won protection.

MITI and other agencies claimed that their protective measures were designed to smooth the downsizing, provide a social safety net, and ease the transition to Japan's next industrial phase. In reality, measures like the famed “recession cartels” of the 1970s and 1980s<sup>1</sup> did precisely the opposite. They tried to resist the decline, slow it down, or even shift the burden to other countries (i.e., by exporting at “dumping” prices, which forced companies in other countries to take a greater share of global cutbacks).



In the end, a trade pattern that had begun as a way of promoting genuine infant industries was increasingly reduced to a crude protection racket for a host of "has-been" and "never-was" sectors. From cement, paper, and glass, to petroleum refining and petrochemicals, and even the formerly competitive basic steel, it seemed that almost no one was denied insulation from market competition.

Like a permanent crutch that leaves the muscles atrophied, protection left whole sections of the Japanese economy ossified and backward. As a 1995 report of the United Nations Industrial Development Organization (UNIDO) put it:

A major feature of the Japanese economy is the dislocation between the domestic market and the rest of the world. While the former is served by the *uchi* ["inside"] companies —rk], which are among the most inefficient companies, the latter is served by the *soto* ["outside"] companies —rk], which are among the most efficient in the world. Traditionally, the *uchi* have been subjected to a plethora of governmental regulations designed to protect them from foreign competition or newcomers at home. Under these very favorable conditions, the *uchi* have not been motivated to reduce their fixed costs and improve their competitiveness vis-à-vis foreign producers [emphasis added].<sup>2</sup>

Look, for example, at food processing and textiles in Table 2.1. Japanese productivity in food processing is an astonishing *one-third* of U.S. performance and *losing ground*. In textiles, it's almost as bad. Yet, almost 2 million people work in food processing alone, more than in auto, auto parts, steel and metalworking combined. And another 1 million work in textiles.

The weak sectors so far outweigh the strong that, when it comes to overall manufacturing productivity, Japan still lags behind even the Europeans, let alone the U.S. (see Table 2.2).

Only half of the overall gap in manufacturing productivity between Japan and the U.S. can be accounted for by such tangible factors as education of the labor force, capital-labor ratios, plant size, age of equipment, composition of manufacturing, and so forth. The other half, say experts, is caused by management practices, and those practices in turn highly depend on whether or not managers face competitive pressures forcing them to improve. In the export market, those pressures are intense; in the domestic sectors, they are often absent.<sup>3</sup>

Japan's handling of its petroleum refining industry shows the system at

Table 2.2

**Manufacturing Real Value-Added per Hour, Percent of U.S. Level**

|         | 1970 | 1975 | 1980 | 1985 | 1990 | 1993 |
|---------|------|------|------|------|------|------|
| France  | 73.3 | 78.5 | 89.8 | 89.8 | 91.3 | 87.8 |
| Germany | 78.7 | 87.3 | 95.2 | 90.5 | 85.9 | 82.5 |
| Japan   | 44.5 | 54.1 | 66.2 | 69.9 | 77.9 | 76.2 |
| UK      | 51.3 | 53.0 | 52.3 | 58.3 | 66.0 | 69.8 |

Source: See Table 2.1

its worst. In the interests of "energy independence" Japan insisted on developing its own indigenous refiners rather than either importing refined oil or relying on the foreign refiners already ensconced in Japan, such as Exxon. As Hugh Patrick has explained:

The greatest MITI failure, however, has been in the way it handled scale and entry in the petroleum refining industry. In order to reduce the large foreign share in Japanese oil refining, MITI promoted the entry—under pressure from a number of business groups each of which wanted a piece of the action—of a large number of too-small refining plants and companies with inadequate capacities to upgrade facilities to optimum scale. . . . These mistaken policies and programs have carried over into some petrochemical products as well.<sup>4</sup>

Having let new domestic companies into the petroleum refining business, MITI felt obliged to shield them not only from foreign competition but even from a Darwinian shakeout at home. In order to avoid excess capacity and "excess competition," the 1962 Petroleum Industry Law liberalized imports of crude, but retained MITI control over imports of refined petroleum products. Moreover, the law required firms to get MITI approval before investing in new capacity.<sup>5</sup>

Despite attempts to shift the costs onto consumers instead of industry, Japanese inefficiency in petroleum was so great that even industrial consumers of petroleum products had to pay prices much higher than world levels.<sup>6</sup> This created a domino effect. Because protection of the refining sector made petrochemicals inefficient, the latter too required unusual assistance. MITI's right hand (the Energy Agency protecting petroleum refining) and its left hand (the Basic Industries Bureau promoting petrochemicals) were working at cross purposes. Unlike steel, which started off as a ward of the state but eventually



stood on its own and became an export superpower, petrochemicals never really did.

Even with this protection, petroleum refining still could not compete. Even worse, the U.S. and Europe were pressuring Japan to liberalize imports. Tokyo did so its way. In 1986, MITI had a law passed which liberalized imports of industrial products, but allowed only Japanese refiners to import consumer-oriented petroleum products like gasoline. Behind the protection of this law, MITI officials organized a secret and illegal cartel among six Japanese refining companies to raise prices by restricting supply. Although high-priced consumer products supplied the brunt of refinery profits, the system ended up raising all prices, even on industrial users. Industry protested the high prices, as did MITI sections with industry clients. Still, the protesters had to wait until 1996 when this 10-year law finally expired. When it did, gasoline prices fell 25 percent even before the first gallon of imports arrived.<sup>7</sup>

The non-manufacturing sectors that make up more and more of Japan's economy have even less exposure to international competition. Hence, productivity in these sectors is particularly backward.

Consider wholesale and retail trade, where productivity is only 44 percent of U.S. levels. This sector employs 11 million people—more than a fifth of Japan's entire workforce and almost as many people as in all of manufacturing. It accounts for 12 percent of GDP. Shielded from both foreign direct investment and local competition, it provides "disguised unemployment" for hordes of mom-and-pop shops, cushy profits for layer upon layer of middlemen, and a huge voting bloc for the LDP. Former MITI official Taichi Sakaiya reports:

One widely heard aphorism is that, while America needs two people to build a car and one to sell it, Japan requires one person to build a car and two to sell it. The average retail price in America is 1.7 times the factory invoice price; in Europe, it is also less than 2 times the factory price. Only in Japan does it hit an incredible 3 times the factory price. It costs Japan 2 to 3 times as much to sell a car as it does for Europe and America.<sup>8</sup>

Then there's construction, where the Economic Planning Agency found that Japanese firms bid up to 45 percent higher than American firms for the same contract.<sup>9</sup>

Costs are so high because the industry is pervaded by an illegal, but protected, system called *dango* in which bidders agree ahead of time on who will get the winning bid. As one of Japan's biggest indus-

tries—10 percent of its GDP and of its workforce—construction lies at the heart of Japan's daisy-chain of inefficiency.

This industry can charge high prices because *half* of its output goes to public works projects. An incredible 90 percent of these public works contracts involve *dango*. This industry, in turn, is a transmission belt to the taxpayer of the excessive prices charged by many of Japan's other moribund sectors. It is one of the biggest purchasers of materials, from cement to glass to steel. Half of all Japanese steel is bought by the construction firms. These materials industries comprise about a fifth of Japanese manufacturing.<sup>10</sup>

Yet, the industry and its suppliers are politically untouchable since the construction cartel provides much of the under-the-table money that feeds Japan's politics. Gavan McCormack reports:

When sudden light was cast on the inner workings of the system in 1993 and 1994, it was learned that 1 percent of all public works contracts of up to ¥2 to 3 billion [\$16 to 24 million] and 0.5 percent in cases of contracts for sums of more than ¥10 billion, had been going in gifts to politicians. . . . Given the scale of the public-works budget, this means that more than ¥300 billion annually [\$2.4 billion a year —rk] was being diverted from the public to political or private ends.<sup>11</sup>

In 1994, says McCormack, 111 out of 511 former Ministry of Construction bureaucrats were found to have moved from the bureaucracy either to the big construction firms they formerly supervised or else into related semipublic entities.

That kind of money and connection buys a lot of protection. No wonder U.S. efforts to pry open the construction industry have proved futile. So have efforts to pry open some of construction's suppliers like glass and cement where cartel-like activities are equally prominent and productivity equally terrible.

In 1997, a senior MITI official said it was politically imperative to cut public works spending, not so much to reduce Japan's astronomical budget deficit, but to cut off the money flow to the construction industry's parliamentary caucus (*zoku*) inside the LDP.<sup>12</sup>

Poor productivity is not limited to traditional industries. It afflicts even telecommunications, another shielded sector that is a make-or-break industry for Japanese ambitions in high tech. Due to the near-monopoly of the quasi-state-owned Nippon Telephone and Telegraph (NTT), labor productivity is only 77 percent of U.S. levels while the productivity of capital is a dismal half of U.S. standards.<sup>13</sup>



It is often said that sectors like retail trade and construction are "non-tradables." But, in most countries there is plenty of international competition via foreign direct investment. Foreign-owned firms are a big part of the U.S. retail scene as are foreign-based contractors. There is no reason these sectors could not be subject to international competition—if only Tokyo wanted them to be. But in Japan, foreigners account for only 0.1 percent of total direct investment (i.e., setting up companies rather than buying stocks). This compares to 4 percent for France, 7 percent for the U.S. and 13 percent for Britain.<sup>14</sup>

Japan's dual economy was not always so extreme. The syndrome emerged in the 1970s in the aftermath of the oil shock and other fundamental trends. The real problem was not the external shocks *per se*, but Japan's poor response.

As the dual economy syndrome grew, it fed on itself. The weaker the lagging sectors got, the more protection they demanded—and got. That just rendered them even weaker.

In the terms of analyst David Asher, the archetype "developmental state" had transformed itself into an "anti-developmental state."<sup>15</sup>

Unless Japan overcomes its dualism, warns Michael Porter in *The Competitive Advantage of Nations*, its future is in danger:

While domestic rivalry is intense in every industry in which Japan is internationally successful, however, it is *all but absent in large sectors of the economy*. In fields such as construction, agriculture, food, paper, commodity chemicals, and fibers, there are cartels and other restrictions on competition, some sanctioned by the government. Almost none of these (and other similar) industries have ever achieved international success. . . . The absence of effective competition in large sectors of the economy is a danger signal and represents a serious challenge to continued Japanese economic advancement . . . [emphasis in original].

Most importantly, government policies in a range of industries has had the effect of undermining competition and sheltering inefficient competitors, lowering the overall productivity of the economy. . . .

Limits on competition in one form or another have also led to inefficiency in a wide range of other fields. . . . MITI-sanctioned "recession" and "rationalization" cartels, which suspend rivalry and involved *de facto* protection, have preserved unproductive firms in dozens of other industries. Only a handful of the more than sixty industries involved have subsequently achieved international success.

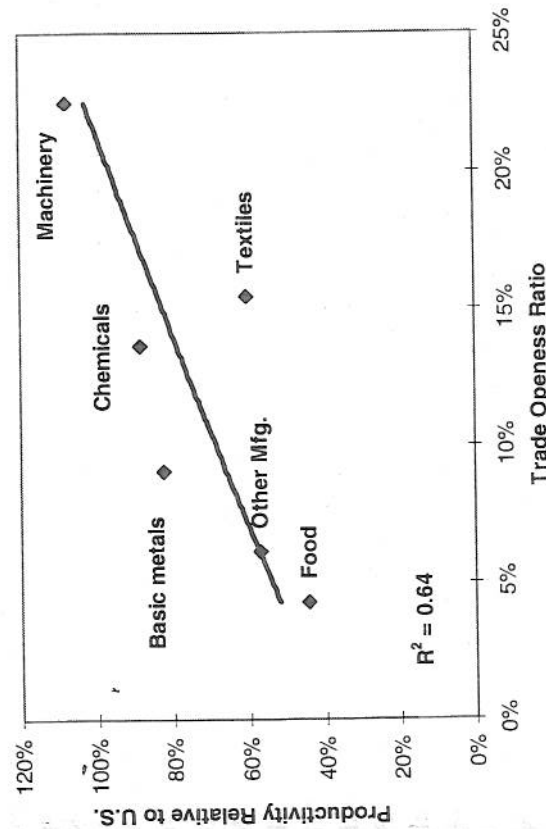
Japan, then, is characterized by some of the fiercest domestic rivalry of

any nation juxtaposed with large areas of little or no rivalry. . . . [This is a] danger signal for the future.<sup>16</sup>

### Import Barriers: The Bodyguard of Domestic Cartels

Japan's trade patterns are the linchpin of the entire dual economy (Figure 2.1). The country's best performers are the industries that face world competition through either exports or imports or both. These industries come closest to matching or beating their U.S. competitors. By contrast, the industries shielded from world competition, i.e., with low exports and low imports, are horribly inefficient by world standards. Japan's exporters are efficient *because* they face world competition; Japan's domestic sectors are inefficient *because* they do not. In fact, an industry's relative openness to trade can explain about two-thirds of how its productivity stacks up compared to its U.S. counterpart (that is the meaning of  $R^2 = 0.64$  percent in Figure 2.1).

Figure 2.1 More Exports and Imports Mean Higher Productivity

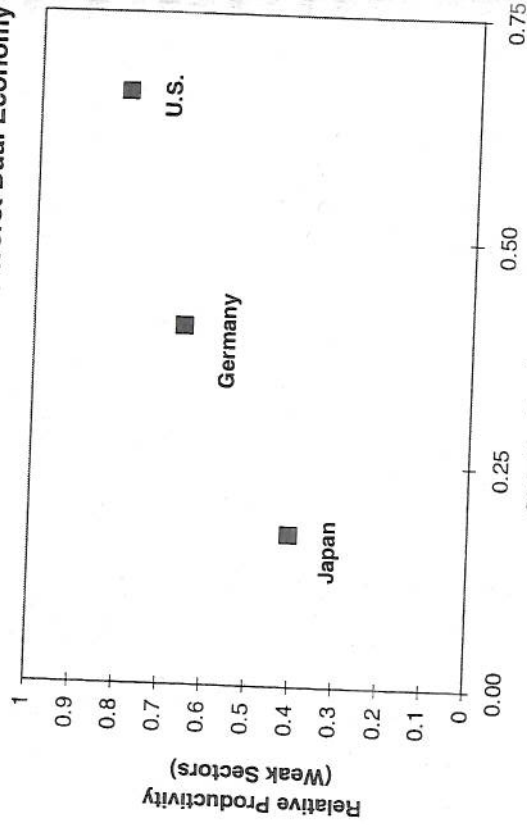


Source: EPA (1995a), van Ark and Pilat (1993)

Note: The data is for Japan in 1987. Trade Openness = Exports as % of Output, plus Imports as % of Consumption. Productivity = Total Factor Productivity (productivity of capital plus labor) of each industry relative to the U.S. level.  $R^2 = 0.64$  means that 64% of the difference in each sector's relative productivity can be explained by the trade openness ratio.



Figure 2.2 Japan Has the Industrial World's Worst Dual Economy



Source: McKinsey Global Institute (1993), Exhibit S-4 after Pg. 4.

Note: Globalization refers to McKinsey Index for exposure to international competition. The number is average globalization of the sectors in which a country's industry lags behind world leaders. Relative Productivity refers to the average productivity of each country's lagging sectors relative to the international productivity leader in their industry (e.g. Japanese processed food at 30% of U.S. level). Japan's weak sectors had the lowest globalization and the worst relative productivity.

Goldman Sachs' Tokyo office found the same result when it compared a series of exporting versus domestic industries. In a typical example, the internationally exposed shipping industry cut its fixed costs during 1984–94. In the same period, the sheltered food and beverage industry let its fixed costs almost double. Productivity expert Dale Jorgenson picked up the pattern in his comparison of U.S. and Japanese productivity in 28 different industries. Over the period from 1960 to 1970, Japan largely closed the productivity gap in nine export-oriented manufacturing industries while it failed to close the gap in the rest of the economy.<sup>17</sup>

To a limited degree, trade-related dualism exists in other countries as well. McKinsey Global Institute has found that, in all countries, those sectors facing world competition are a lot closer to matching the world's benchmark leader than sheltered sectors. But, in no other country is the gap between international and domestic sectors so great as to give rise to an extreme "dual economy" (see Figure 2.2).<sup>18</sup>

Germany may not have any broad sectors that outshine the U.S. in

efficiency, but neither does it have any broad sectors that lag far behind world standards. On average, its manufacturing productivity is higher than that of Japan (right-hand column of Table 2.1).

The claim to fame of Japan's industrial policy is that it is supposed to accelerate an economy's shift of jobs, output and investment from low-productivity sectors to high-productivity sectors. There's plenty of evidence that Japan's industrial policy did just that in the 1950s–60s, as we'll explore in Chapter 6. However, in the past decade or so, Japan's protectionism has done just the opposite.

Compare how the U.S. and Japan have responded to the forces of globalization and rising currency rates. The U.S. response has made it stronger; the Japanese response made it weaker. In the U.S., when the dollar rose, both exporting industries and import-competing industries were forced to improve their productivity in order to compete. In Japan, by contrast, only the exporters have faced that pressure. Indeed, Japan's dual economy is so distorted by its protectionism that, under the pressure of a rising yen, Japanese workers actually shifted from the efficient sectors into the inefficient, exactly the opposite of the U.S.

This effect is seen in Table 2.3. In the early 1980s, the rising dollar forced exporters to raise their prices, thereby undercutting sales. Meanwhile, foreign imports into the U.S. were now cheaper, making it harder for American firms to sell unless they lowered prices and hence profits. In order to stay in the game, both exporters and import-competing sectors had to improve their productivity. And both sectors did, almost to the same degree.

In Japan, by contrast, when the yen rose in the late 1980s, only high-export industries felt the pressure and they showed good productivity growth. The low-export industries, shielded from competition from imports, performed very poorly.

In the early 1990s, another ratcheting upward of the yen coincided with Japan's recession. As is typical of recessions, reported productivity is negative. Once again, the low-export, low-import sectors performed much worse than the exporters. But notice that, while high-export sectors shed workers to restore competitiveness (while raising the wages of those workers who remained), the low-export sectors shielded from competition hardly downsized at all. In relative terms, there has been a shift of workers from high-productivity to low-productivity sectors! The opposite pattern took place in the U.S.: low-productivity, low-export sectors shed the most workers.







processing, and so forth). This has not only sapped Japan's overall vigor, but, as we'll see in Chapter 3, is driving Japan's most efficient industries to leave the country and invest offshore.

Low imports do not directly create Japan's inefficiencies. That, as we shall see, is created by domestic collusion, cartels and other anti-competitive practices. But there is no way domestic industries could get away with these slipshod practices if imports were free to come in and seize the markets.

If imports were freely available, how could Japanese producers manage to charge domestic customers 60 percent more than world prices for steel, 70 percent more for cement, and 64 percent more for petrochemicals? Not surprisingly, in each of these industries, repeatedly organized into cartels by MITI, imports as of 1992 remained negligible: only 1.2 percent of consumption in cement, 7 percent in steel, and 8 percent in petrochemicals.<sup>19</sup>

*Import barriers are the indispensable bodyguard of domestic cartels.*

True, Japan restricted imports during the high-growth era. But over time the targets of protection shifted from infant industries to senile industries, from protecting the future to protecting the past.

It is not the case, as is so often assumed, that Japan has always protected everything in sight. The degree of protection has always varied widely from sector to sector. In the high-growth era, it was the "strategic" or "developmental" sectors that received the most protection. In 1963, the highest effective rates of tariff protection were accorded to sectors that were either currently high exporters (textiles, steel, and the shipbuilding portion of transport machinery) or would become export superstars in the future (like electrical machinery, the automotive portion of transport machinery)—in other words, sectors that either already enjoyed international competitiveness ("comparative advantage" in the economics jargon), or were gaining it (see Table 2.4).

In fact, as export strength increased in the machinery sector, protection became increasingly superfluous and was steadily reduced. The more exports rose as a share of output, the smaller the tariffs became (Figure 2.4). On the whole, formal protection steadily fell in the high-growth era as tariff rates halved from 32 percent in 1963 to 14 percent in 1973.

Had this pattern continued, perhaps Japan would have become a liberal trading partner.

Then came the 1973 oil shock. Once again protectionism reared its head. But now the targets were very different. By 1978, sectors getting

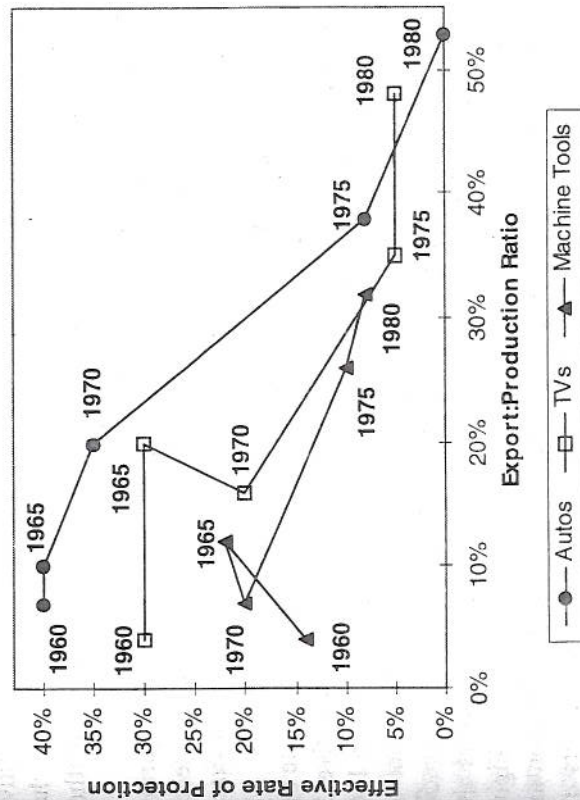
Table 2.4

## Effective Rates of Protection by Industry (%)

|                             | 1963 | 1968 | 1973 | 1978 |
|-----------------------------|------|------|------|------|
| Manufacturing               | 32   | 24   | 14   | 22   |
| Textiles                    | 54   | 28   | 18   | 38   |
| Wood products               | 14   | 25   | 16   | 18   |
| Paper and pulp              | 10   | 18   | 11   | 9    |
| Leather and rubber products | 31   | 22   | 12   | 14   |
| Chemicals                   | 33   | 18   | 15   | 12   |
| Petroleum and coal products | 19   | 14   | 7    | 19   |
| Iron and steel              | 30   | 30   | 17   | 19   |
| Nonferrous metals           | 30   | 34   | 22   | 21   |
| Metal products              | 14   | 20   | 10   | 6    |
| Machinery                   | 37   | 20   | 8    | 6    |
| General machinery           | 23   | 14   | 9    | 6    |
| Electrical machinery        | 31   | 16   | 5    | 7    |
| Transport equipment         | 61   | 31   | 9    | 3    |
| Precision instruments       | 35   | 23   | 10   | 6    |

Source: Itoh and Kiyono (1988) pg. 161

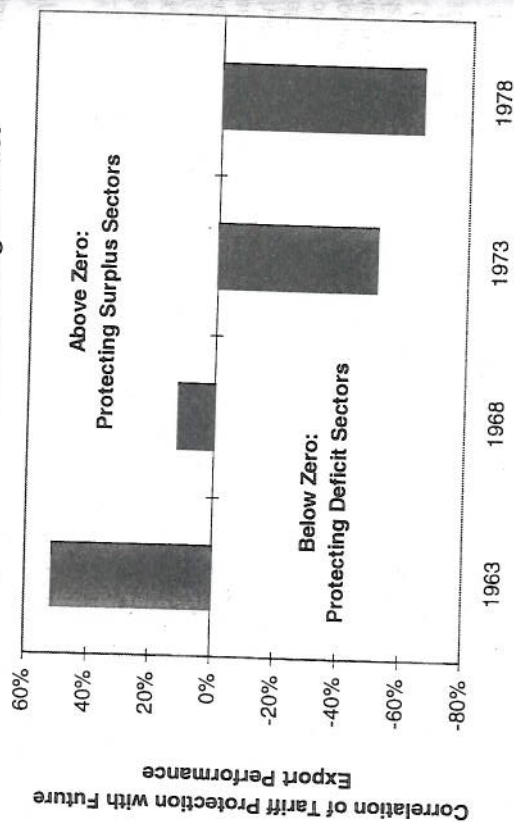
Figure 2.4 As Exports Go Up, Tariffs Come Down, 1960-80



Source: Adapted by author from Itoh and Kiyono (1988), Pg. 162



Figure 2.5 Protecting the Future Vs. Protecting the Past



Source: Table 2.4 for ERP, for Net Exports:Output Ratio, Tilton (1996), pg. 11

Note: For explanation, see text.

the most protection were either ones where Japan's former competitiveness was eroding (textiles, metals) or ones where Japan never had competitiveness in the first place (wood products, paper, leather, chemicals).

This shift is illustrated more precisely in Figure 2.5. For various years, we measured the correlation between the tariffs for each sector for a given year and the trade performance by that sector in *future* years.

In 1963, the sectors getting the biggest tariff protection were those that had the biggest trade surpluses 20 years later. There is a positive 51 percent correlation between the size of a sector's tariff protection in 1963 and the size of the sector's trade surplus in 1982. But as time went on, the link between tariff protection and future export prowess steadily dropped. By 1978, the biggest tariffs were now going to sectors that showed a trade *deficit* a decade and a half later. That is shown in Figure 2.5 by the 64 percent *negative* correlation between tariff protection and the size of the sector's net exports. Japan was now protecting its uncompetitive "has-been" and "never-was" sectors.

### The Industrial Cartels: Enforcers of Import Barriers

The Japanese government has claimed that all the import barriers are gone. Tariffs are now low. And yet the numbers show a nation that uniquely imports very little in the way of competing goods. Where are the "invisible barriers"? Is the government pulling strings behind the scenes?

In a few cases, government involvement is still operating. Formal barriers (like petroleum restrictions through 1996) and/or informal "administrative guidance" (warnings to importers of textiles not to overdo it) provide the "visible hand." But, most often these days, the government just provides a tolerant, or even supportive, environment. The key enforcers are in the private sector.

"To see how it works, check out the industry associations," one Japanese banker told me. Under the shelter of legal cartels in the 1970s and 1980s, and, these days, a blind eye by the Japan Fair Trade Commission (JFTC), associations of producers and users regularly collude. They agree on a price and boycott those who don't go along. This process is detailed in an illuminating new book by Mark Tilton, *Restrained Trade*.<sup>20</sup>

In the cement industry, where five companies control about 60 percent of sales, Tilton reports:

Construction trade associations agreed to buy only from members of the domestic cement trade association, while members of the cement association agree to sell only to construction association members that abide by the agreement. If a construction company buys imported cement, domestic [cement] companies will no longer sell to that company. . . .

[In] Kobe, the dock workers union formally refused to unload the cement [that one construction company tried to import]. . . . The longshoring company said it could not do the work because Japanese cement companies had told it they would no longer give the company work if it handled foreign cement.<sup>21</sup>

The same applies in steel, where five firms control about 70 percent of sales, and where Nippon Steel and Toyota get together every year and negotiate the "big buyer price." Even the powerful Mitsubishi Heavy Industries (MHI) was threatened with a cutoff of supplies and other retaliation when it wanted to buy a bit of steel from Korea's Pohang, whose prices were a third less than the Japanese cartel's price. Despite prices 60 percent above world levels, the much-vaunted opening of Japan's steel



industry was a meager rise from 1 percent of consumption in 1980 to only 7 percent in 1992.<sup>22</sup>

Fear of retaliation is only one factor in this mutual protection scheme. Equally important is the fact that each sector, including exporters like autos and electronics, desires its own protection from imports. So, up to now, no one has wanted to knock over the chessboard.

Now, as we shall see in the next chapter, exporters in autos and electronics and other sectors face a dilemma: the costs are outweighing the benefits.

## Chapter 3

### “Hollowing Out”: Driving Away the Geese That Lay the Golden Eggs

*If current trends continue, in ten years, our company won't export a single item from Japan. Half of our sales will be overseas—even more than the 30 percent overseas sales we have today. But what we sell overseas, we will have to make overseas.*

—Consumer electronics executive, 1995<sup>1</sup>

Back in 1988, Matsushita assembled VCRs in a brand new plant outside of Osaka. An assembly line that seemed to snake around forever was filled with hundreds of robots. Each one did only one simple task. In combination, they added up to an incredibly impressive feat of organization. Its simplicity was its cleverness. The assembly line was built because the rise of the yen since 1985 had compelled Matsushita to double its productivity quickly. Today, that plant no longer exists. It's been moved to Southeast Asia. As the yen kept soaring, productivity hikes at home just could not keep up.

In the last ten years, that story has been replicated a hundredfold. By 1994, half of all Japanese VCRs were made outside of Japan, up from a negligible 6 percent ten years earlier. Already, more TVs and microwaves are made outside of Japan than back home. Refrigerators are almost at that point. More than a third of all passenger cars are made outside of Japan (Figure 3.1).

All of these absent plants are the victims of Japan's dual economy. Ultimately, there is no free lunch. If Japan's inefficient sectors are to be coddled, someone has to pay the bill. As long as the sheep being fleeced were mainly consumers and taxpayers, the system was sustainable, even if inequitable. But, over time, Japan's efficient exporters also began suffering higher and higher penalties due to Japan's protectionist system. As a result, the system is starting to kill the geese that lay the golden eggs. That, in the end, is why the system cannot continue.