POLITICAL ECONOMY OF INDUSTRIAL KEIRETSU GROUPS
IN JAPAN AND THEIR IMPACT ON FOREIGN
TRADE WITH THE UNITED STATES

DISSERTATION

Presented to the Graduate Council of the
University of North Texas in Partial
Fulfillment of the Requirements

For the Degree of

DOCTOR OF PHILOSOPHY

By

Tetsuro Nukumi, B.A., M.A.
Denton, Texas
August, 1993
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titles.

The postwar transformation of the international
environment has caused economic issues to become a main
source of contention among industrial states. The trade
imbalance between Japan and its trading partners became a
major source of conflict. Reciprocity of access and opening
the market of Japan became the main point of debate and the
major issue affecting relations between Japan and the United
States.

While the distinction between the domain of domestic
and international politics increasingly is blurred,
different domestic political economies create bilateral
political and economic conflict. The structure and politics
of intercorporate groups or vertical keiretsu are a major
feature of Japan's industrial structure and political
economy. This case study examines how vertical keiretsu in
the automobile and home electric appliance industries affect
the Japanese political economy and international trade. A
political economy approach focuses on the political context
of economic phenomena by analyzing both political and
economic variables.

Case studies of keiretsu were used in order to gain an understanding of Japan's political economy. A number of propositions or assumptions about the political economy and the dynamics of keiretsu were examined in these studies.

It was found that vertical keiretsu influences the industrial sector, trade, and foreign policies in Japan. Japan's industrial policies cannot fully be understood without taking keiretsu into consideration. Scholars have not yet fully considered vertical keiretsu as major actors in the Japanese political process. Their political influence on industrial policies has largely been overlooked. Vertical keiretsu in the automobile and home electric appliance industries were found in the case studies to have been shaping industrial policies since the early post war years.

Findings about the nature of Japan's political economy help to explain the conflictive bilateral relationships between Japan and the United States. The findings also show that understanding political economies of nations is increasingly important as the world economy grows and greater trade interaction is imminent.
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CHAPTER I

INTRODUCTION

The dramatic changes in the world's economy and the huge increases in the volume of international trade since the World War II were promoted by the establishment of a "liberal international economic order" which sought to reduce "trade barriers" (Gilpin 1987, 73). The United States and its allies not only promoted a liberal international economic order but also created liberal trade institutions such as the General Agreement on Tariffs and Trade (GATT) and the International Monetary Fund (IMF) (ibid, 73). Postwar trade liberalization, however, was not totally free trade since widespread "visible and invisible national barriers to imports" continued to exist in many nations (Destler 1992, 5). The United States in the early postwar period tolerated protective trade practices by its allies in order to promote economic recovery of Western Europe and Japan and to protect them from the threats of communism. Japan, for example, was able to pursue a "mercantilist trade strategy" by encouraging exports and discouraging imports without much resistance from the United States (ibid, 8). American demands for liberal trade policies was moderated because of its concern over the threat of communism and of containing the Soviet Union and
China (ibid, 7).

As its relative economic power declined in the early 1970s, however, the United States no longer was as tolerant of the nationalistic trade practices of its allies. The assaults by foreign competitors, especially the Japanese on various American industrial sectors, such as steel, consumer electronics, automobiles, microelectronics and computers put America on the defense (Destler, 1992). The burgeoning deficit in the American trade balance which soared from $9.3 billion in 1976 to $99 billion in 1992 caused great consternation and led America to closely examine the policies of its trade partners which placed obstructions on American products entering their markets (Banks 1993, 39).

Japan was the worst culprit in impeding imports into its markets while exporting huge amounts of goods to the United States (Johnson 1989). A major portion of the United States' trade imbalance, in fact, was with Japan. The deficit with Japan had ballooned from $4 billion in 1972 to $11.6 billion in 1978 and to $48.7 billion in 1992 (Keatley 1993, A6). American industries were seriously affected by this huge trade imbalance and political complaints mounted against Japan.

The political conflict and tension between the two nations resulted not only in demands that Japan open its markets to American goods, but also that Japan restrict exports to the United States. Thus, a form of managed trade
rather than purely free trade between the two countries was proposed. This postwar transformation of the international environment caused economic issues to become the main source of contention among industrial states.

Some scholars in the field of international relations, therefore faced a new set of problems and were forced to seek new approaches for explaining the new phenomenon. Traditionally the field had focused almost entirely on security matters, and nation states were considered as the dominant and only worthy actors of study. Both realist and the neo-realist schools in international relations largely ignored non-state actors and viewed economics only as it affects military power of nation states. Throughout much of history national security was the primary focus of the field (Morgenthau 1966). Not until the development of the pluralist school in the 1970s did such scholars as Keohane (1977, 1984, 1989) and Krasner (1976) begin to acknowledge the importance of non-security or economic issues on international relations.

The Pluralist school also recognizes the importance of non-state or transnational actors, such as Multinational Corporations (MNC) and terrorist groups, to the study of international relations. The emphasis of this new approach, however, is mainly on the possibility of cooperation between states because of the growth of international regimes, which pluralists define as "norms, rules, and decision-making
procedures" which develop in given issue-areas as a result of increasing interactions of people and governments (Krasner 1983, 1). Although there remains a potential for conflict among competing states, the pluralists believe that the development of international regimes militates against conflict. Despite the emphasis on international regimes, their analysis is largely state centric. Like realists and neo-realists, they believe that a state's behavior is shaped mainly by interaction among nation states. They perceive states to be rational egoistical actors who are better able to cooperate with others as a result of the development of international regimes. Domestic politics and economics, although they may impact the international environment, are not considered to have a great impact on a state's foreign policy.

Although the Pluralist school acknowledges the increasing importance of non-security or economic issues on international relations, the limitations on the approach cause it to ignore largely the interplay between macro (structural and state centric level of world politics) and the micro dynamics made up of domestic economic and political actions (Rosenau 1990, 25). The pluralists, like others who stress a traditional macro view of world politics, treat domestic politics and economics as constants, despite the fact that the distinction between the domain of domestic and international politics increasingly
is blurred or interwoven (ibid, 42). Governmental power is considered as given by most pluralist scholars, who do not consider domestic politics or sub-national actors to be independent factors in international politics (ibid).

Only recently has it been asserted that the domestic environment is a major factor in shaping a nation's foreign policies. Writers such as Cohen (1991), and Frieden and Lake (1991) now contend that a nation's foreign policy is significantly influenced by domestic politics and economics. They argue that foreign economic policies of states are an outcome of "domestic-level political and economic processes" (Frieden and Lake 1991, 12). For them, shifts in the postwar international economic system, such as the Bretton Woods Agreement, can best be explained by the changes in domestic economic and political factors in the industrial states (ibid, 13). Even among these scholars, however, there are fundamental disagreements about the relative weight of actors affecting foreign policy. Some argue that international sources are primary, while others believe domestic factors in the industrial states predominate (ibid, 3-14).

This study rests on the assumption that domestic factors in Japan dominate the country's foreign policies pertaining to international trade. The structure and politics of intercorporate groups or keiretsu are considered to be major factors in the Japanese political economy and to
influence directly trade policies and practices. Keiretsu came into existence as a result of the government’s industrial policies after World War II and have had a major economic impact on the country. As keiretsu became a fixed part of the economic structure, they gained not only economic but also political power to resist and change policies which they perceived to harm their interests. Foreign policy, as a result, is shaped by these intercorporate groups.

Little attention was given to keiretsu by earlier scholars who studied industrial policies in Japan. Most overlooked the impact of keiretsu on domestic or international politics. Similarly, those who have attempted to explain the domestic industrial politics of Japan have overlooked the political impact of keiretsu. All four of the main policy models for explaining the Japanese political economy, including the neo-classical economic model, the Japan’s Incorporated model, the pluralist industrial policy model, and the latest proposed model, the reactionary ad hoc policy, fail to consider keiretsu as a vital structural aspect of the economy or as an actor in Japanese politics. None of these models of domestic politics considers how keiretsu affect industrial policies.

How states are politically involved in their economies varies according to the way markets are structured (Okimoto 1989, 16). Overlooking the impact of keiretsu on industrial
policy in Japan, therefore, is a serious flaw in these theories of the Japanese political economy. Industrial groups called keiretsu, especially the vertically linked keiretsu, are a major feature of Japan's industrial structure, which cannot be overlooked. These groups play a major role in the politics of industrial policies and constitute one of the major "informal barriers" within the economy affecting the low importation of industrial goods.

Purpose of Study

The main purpose of this study is to gain insight on how keiretsu affect Japanese domestic politics and economics as well as foreign policy. Vertical keiretsu first are examined to see how they developed as economic institutions and how they fit into the Japanese culture. An examination is made to discover the common interests of these intercorporate groups and how they use the domestic political sphere to protect their interest against domestic and international pressures. Also the study examines how the interest of keiretsu affects international trade. It is hoped the study will contribute to theory building of the Japanese political economy and international relations and throw light on the implication of keiretsu for bilateral trade with the United States.
Research Questions and Propositions

A series of research questions are used to guide the study. These questions include the following: 1. What are vertical keiretsu and how do they influence the domestic economics and politics? 2. What is the impact of keiretsu on foreign trade policy? Specifically, (a) Do the vertical keiretsu restrict the entry of foreign products into the Japanese market? (b) How is the government involved in facilitating or protecting vertical keiretsu? (c) Have governmental policies changed toward keiretsu as a result of the increase in international pressures? (d) What has been the reaction of keiretsu to the changes in the international environment?

In addition to these research questions, a number of propositions or assumptions, which are drawn from general observations and understandings of the dynamics of keiretsu, are examined. These assumptions are as follows:

1. The strongest vertical keiretsu tend to be found in industries which produce high-value products, and they are more likely to be found in industries dominated by a few large enterprises.

2. The so-called double industrial structure in the Japanese economy consists of a few large firms making up approximately two percent of the total number of enterprises, and a large number of small and medium
sized firms making up the rest of the industrial firms in the country. This industrial structure is thought to encourage the formation of vertical keiretsu since it is relatively easy for larger firms to manipulate smaller firms to serve only their interests, while at the same time, vertical keiretsu provide financial and managerial support and security for the small companies.

3. A main factor influencing the growth of keiretsu is the government's pro-business industrial policies.

4. Traditional Japanese business practices also support the development of keiretsu since businesses long have relied mainly on long-term personal relations, rather than purely on economic rationality which emphasizes mainly price and quality. Close ties and relationships between Japanese firms are given first priority in the making of economic decisions, in contrast to business practices in the United States where decisions rest mainly on economic rationality.

5. Business practices of keiretsu stress group cohesiveness which tends to exclude all outsiders, including domestic competitors. Their purpose is not necessarily to restrict imports of foreign products into the Japanese market.

6. Keiretsu, as in all business entities, tend to protect their vital interest through the political
process. Once fully developed, keiretsu became politically powerful entities, and thus government cannot enact major changes in domestic or foreign economic policies without their support.

These propositions, assumptions and general understanding along with the research questions are examined through case studies of the Japanese automobile and the home electric appliance industries.

Significance of the Study

The growing conflict between the United States and Japan over international trade threatens to undo the liberal international economic order which has flourished since World War II. Sub-national actors in Japan, the keiretsu, are thought by many to be the major actors shaping the economic and trade policies of the nation. An understanding of the dynamics of domestic politics in Japan and how these dynamics affect foreign policy is essential if we are to understand the political economy of Japan and the obstacles to free trade between the two industrial leaders in the world today.

Although a number of studies dealing with keiretsu exist, most have centered on "kigyo shudan" or six large horizontally linked inter-corporate groups. Few studies have focused on vertical keiretsu and even fewer have examined them in a political context to see how they impact
foreign policy or bilateral trade relations. The relevance of this study is that it examines whether keiretsu have structural barriers to international trade and whether they are a factor in causing the conflict between Japan and the United States.

The automobile and household electronic industries are chosen as the focus of the case studies because both of these industries are among Japan's largest and most important. They contribute more in foreign earnings than any other Japanese industries. Export of automobiles, for instance, earns a huge amount of foreign exchange for Japan, as evidenced by the fact that about two-thirds of the total American trade deficit with Japan or $31.5 billion out of a total $48.7 billion as of 1992 resulted from the import of Japanese automobiles and auto parts (Pollack 1993, C16). Japanese cars now dominate approximately one third of the American market (Automotive News May 26, 1993, 19). This industry continues to be at the center of the conflict between the United States and Japan.

Competition from Japanese television since the 1970s has increased as a surge of cheaper television sets flooded the American market. This flood of Japanese electronic products, particularly color televisions, had a devastating effect on the American television industry. The number of American television producers as a result declined from 27 firms in 1960 to 5 producers in 1980, and only 3 of these
companies, General Electric, Zenith, and RCA were competitive with the Japanese (Yamaura and Vanderberg 1986, 259). As of 1993, only Zenith still produces color televisions in America. Employment in the industry followed a similar pattern and declined by 50% between 1966 and 1970 (ibid, 258). Political opposition to Japanese imports intensified as the numbers of imported Japanese products grew. American industries and labor unions both petitioned government to restrict Japanese products. They claimed that Japan was unfairly dumping products in America.

Microelectronic parts such as chips or semiconductors in the home electric appliance and computer industries are another more recent seed of discord between Japan and the United States. Trade tensions between the countries center on standardized electronic parts, such as chips or semiconductors. Much of this technology was developed in America, which dominated the world market for these essential electronic parts without serious competition until the early 1970s. However, as the Japanese computer industry developed and grew competitive, Japan's percentage of the World semiconductor market increased rapidly as the American share of the world market fell sharply. Worldwide the American share dropped from about 63% to 43.8% in the period from 1984 to 1992 while Japan's share was increasing to a competitive 43.5% in 1992 (Brandt 1993, 80). In Japan, the United States' share fell about 80% since 1979 to 30% in
1987 and 14% in 1988 (Cole 1989, 63). As a result of the American pressures during the Bush administration, the American share of the Japanese market increased to nearly 20% by the late 1992. The fact that American exports to Japan did not increase proportionately to Japanese exports led American industrialists to press for establishing requirements on Japan to purchase at least 20% of foreign parts.

In recent years America charged Japan with closing its markets to foreign manufactured products. Increasingly, keiretsu in the automobile and home electric appliance industries are accused of being monopolistic and of being a major obstacle to outsiders doing business in Japan. The case studies of the vertically linked keiretsu for the automobile and the home electric and electronic industries should provide valuable insights as to the structure and dynamics of the political economy of Japan and their impact on trade with the United States.

Methodology

Case studies are made of the vertical keiretsu in the automobile and home electric appliance industries in order to gain an in-depth understanding of Japan's political economy. Case studies according to many scholars contribute to establishing "general propositions and thus to theory building" by allowing in-depth observation of social,
economic, and political phenomenon (Lijphart 1971, 691). As in most case studies, this research depends heavily on historical analysis. The general framework uses the political economy approach which stresses non-separation between economic and political variables. According to Ferguson and Rogers, there is no single method in a variety of studies of political economy. They state that:

The richness and variety of current studies in political economy makes it impossible to specify a single methodological approach that dominates and defines the field. Political economy may nevertheless be usefully understood as reflecting a general set of concerns and assumptions about the nature of economic and political power that are highlighted by the rise of the interventionist state and the advent of what has been variously denoted as 'modern,' 'political,' 'welfare,' or 'organized' capitalism. Here what has newly gained acceptance within political science are the elementary propositions that political institutions and decisions critically affect the conditions of economic activity, and that the structure and articulation of economic interests determine much of what once passed as pristine political process.... Most basically, then, and whatever its varied expression, the political economy perspective rejects any presumption of a sharp separation between economic and political power (Ferguson and Rogers 1984, vii).

This study assumes the importance of both economic and political variables and their interdependence in explicating the bilateral trade pattern. Unlike the liberal perspective of International Political Economy, which tends to stress the economic model for explanation of politics, and the Marxist tradition of political economy, which emphasizes international dialectic systemic analysis, the political economy approach used in this study focuses on the political
context of economic phenomenon.

Limitations of the Study

Limitations of this study include the following:
first, an analysis of this study is not intended to assert
the comprehensive causal factors for the conflict between
Japan and the United States over trade. This study assumes
that in the industrial sector of manufacturing, performance
of foreign trade has been greatly influenced by the
industrial structure of Japan, principally the vertical
keiretsu examined here (Cohen 1991, 14). Second, the case
study method employed in this analysis is intended to
generate propositions about the impact of keiretsu in
Japanese foreign policy rather than to test hypothesis.

Data Sources

Documents, books, official reports, articles, and notes
in various magazines, journals, and newspapers are utilized.
Both English and Japanese language sources are examined, the
most pertinent being:

(1) Economic and trade journals such as Economic Eye,
Economist, Far Eastern Economic Review, International
Management, Journal of International Economy, Columbia
Journal of World Business, Japan Quarterly, Journal of
Japanese Trade and Industry, Tokyo Business Today,
Shukan Daiyamondo, Chuoh Koron, Ekonomisuto, Keizai
Ronso, Nikkei Business, etc.

(2) Government reports such as Keizai Hakusho, Tsusho Hakusho, Kosei Torihiki.


Organization of the Dissertation

This study consists of eight chapters.

Chapter I states the purpose and significance of the study, the methodology, and sources of data.

Chapter II reviews the literature of keiretsu. The review examines definitions and types of keiretsu, analyzes the causes, motives, purposes of keiretsu, and the methods of operation in the domestic environment. It also examines the effects of keiretsu on the domestic and international economy.

Chapter III is a case study of vertical keiretsu in automobile production. This chapter analyzes automobile production keiretsu, including their characteristics, development, impact on the domestic and international economy, and recent changes which have occurred in these organizations.

Chapter IV is a case study of vertical automobile distribution keiretsu. It analyzes the formation of the
distribution keiretsu, the impact on the domestic and international economy, and recent changes they have experienced.

Chapter V is another case study of the production and distribution keiretsu in the Japanese home electric appliance industry. The first section examines the general characteristics, formation, and impact of the production keiretsu on the domestic and international economy. The latter section analyzes distribution keiretsu in the industry in terms of their impact on the domestic and international economy as well as recent changes in the distribution keiretsu.

Chapter VI considers the political context of vertical keiretsu. An examination is first made of the role of government in the Japanese economy. The most prevalent Japanese political economy models are analyzed to see if they are capable of explaining the development of industrial policies. Application of anti-monopoly laws to keiretsu of automobile and home electric appliance industries next are examined to determine the regulatory relations between government and keiretsu. Finally the changes which have occurred in governmental policies as Japan developed industrially are considered, along with the increasing role of keiretsu in determining these new policies.

Chapter VII investigates the effect of growth and internationalization of industry on Japanese politics. The
impact of policy changes on vertical keiretsu in the automobile and home electric appliance industries are first analyzed. How Japanese policies and the growth of these industries affect its trading partners next is considered.

Chapter VIII, the final chapter, provides a general conclusion based on the analysis of the political context of the vertical keiretsu in the automobile and home electric appliance industries, and how they affect trade relations between Japan and the United States.
CHAPTER II

REVIEW OF THE LITERATURE

This chapter reviews the literature on Japanese industrial groups known as keiretsu and describes the political economy of these groups. It looks at the difficulties of defining keiretsu and explores the various types. This chapter also reviews the literature pertaining to the causes of their appearance, their motives and purposes, and the impact they have on member firms, the domestic economy, and international trade.

Scholars have examined various aspects of keiretsu in recent years. Some have traced their formation and their purposes and functions, but few have examined vertically linked keiretsu and their impact on member firms, the domestic economy, and international trade. Most studies have centered on the six largest horizontally linked industrial groups, the so-called "kigyo shudan." There is little agreement among these studies as to a definition or typology of keiretsu.

Lack of Agreement as to the Definition and Nature of Keiretsu

Whenever the Japanese industrial structures or industrial groupings are discussed and analyzed in the
literature, the lack of agreement about the nature and
definition of industrial groups becomes obvious. The
literature reveals little agreement about the nature of
these groups. This is true among Western scholars, but it
also applies to the works of Japanese scholars. This
absence of agreement or understanding about the nature of
keiretsu was described by Henderson:

For one thing, the cast of firms in each keiretsu has
changed some from year to year as a result of mergers
and structural changes in the economy, but even more
baffling is the variety of classifications to be found
in any given year, even among Japanese writers,
presumably because strong firms are only loosely
related to any given keiretsu.... So, too, the inner
workings remain perplexing, not only because the
sprawling keiretsu are extremely complex, but also
because they are so subtle that our usual western
analysis based on a majoritarian mentality and also its
Japanese manifestations in the corporate laws, confuses
as much as it explains (Henderson 1973, 139).

Some have attempted to define keiretsu narrowly,
including only corporate groups linked by financial ties
(Miyazaki 1980), such as the six major horizontally
affiliated corporate groupings of Japan (Hadley 1970).
Others define them as corporate ties between a primary
manufacturing firm and its subcontractors, the so-called
vertically affiliated firms (Yoshino 1968, 148). Still
others designate keiretsu broadly, describing them as any
"corporate groupings" (Aoki 1988, 119-120), "industrial
grouping" (Okimoto 1989, 132-133), "group of affiliated
companies" (McCrow and O'Brien 1986, 79), "linked groups" or
"affiliated groups" (Bieda 1970, 210), or "powerful groups
of affiliated firms" (Fujigane and Ennis 1990, 26-27).

Still more inclusively, others view keiretsu as "organizational principles little more than a confederation" (Czinkota and Woronoff 1986, 28). These writers describe keiretsu as a "web of relationships, ranging from tight to loose, among companies working together" (Imai 1990, 24), or as a "group of firms in different industries that maintain significantly closer interfirm relationships than those seen among autonomous (non-keiretsu) firms" (Wassmann and Yamamura 1989, 120-121).

Additionally, writers neither agree on whether the term keiretsu applies only to firms having a continuous business relationships nor on whether it requires additional factors, such as reciprocal share-holding, interlocking directorship, mutual investments, mutual assistance of technology, or demonstration of a common company loyalty or spirit (Lawrence 1991, 313; Negishi 1990, 1).

The nature of the business relationships between the firms in a keiretsu raises a number of questions. Must there be financial ties between companies in a keiretsu or can the relationship be only contractual? Are all keiretsu made up of companies with close social ties developed in organizations such as the president's clubs (shacho kai) or cooperative associations (kyoryoku kai)? Must all have a common company loyalty or spirit? When corporate firms have a parent and subcontract or subsidiary relations are they
necessarily keiretsu? Are all firms with reciprocal share holding necessarily keiretsu? There is no clear answer to these questions, illustrating the difficulty of assessing these industrial groupings in scholarship and policy making.

Although the concept of special and enduring corporation relations is useful in helping to define a keiretsu, it presents new problems. Problems are rooted in the disagreement over types of relationships between firms in a vertical keiretsu. If a manufacturer has only a contractual relationship with its distributors, the question asked is whether this is a keiretsu, or whether it matters if it has other special relationships such as close social ties and a common spirit? Affiliated firms (kankei gaisha) where the parent company owns a portion of the affiliate presents another situation. What percentage of ownership of the affiliate creates this relationship? The Japan Fair Trade Commission and the scholar, Okumura (1985, 201), hold that it (kankei gaisha) requires a parent firm to own over 10% of the affiliate. Others hold that unless the parent company possesses over 20% the shares of a company, it is not an affiliated firm (Aoki 1988, 120-122; Mitsubishi Research Institute 1987, 4; Sakamoto and Shimotani 1989, 52). Neither is there any agreement about when a firm is an affiliate or a subsidiary owned by the parent company. Some say if the parent company owns more than 50% of the firm, it is a subsidiary and treated as a part of the parent firm,
but there is no consensus as to the percentage. These issues pose serious problems for scholars seeking to understand the dynamics of the Japanese economy and its relations with the global economy.

Keiretsu are defined in this study broadly as two or more independent firms having special and enduring corporate relations (Negishi 1990, 3). The special corporate relations may include either mutual or unilateral stock holdings, a primary firm’s ties with its subcontractors and subsidiaries, or a relationship where business officers are interchanged from parent company to the subsidiaries or subcontractors. These special relations also frequently include close social ties among the officers of the firms which are cultivated in social clubs called the president’s clubs (shacho kai) for executives of firms in horizontal keiretsu or cooperative associations for those in vertical keiretsu. Such clubs in part are a means of encouraging group cohesion, simultaneously promoting interpersonal relations and business. Cooperation associations (kyoryoku kai) act in the same way as president’s clubs except they serve vertical keiretsu where there are suppliers or retailers for a large manufacturer.

Types of Keiretsu

Most students of the Japanese economy, Japanese and Westerners alike, only perceive keiretsu to be the six
horizontally linked industrial groups or "kigyo shudan." They evince little knowledge or appreciation for the importance of various types of industrial groups, including the significance of vertically linked keiretsu.

The failure to recognize and appreciate the various types of keiretsu creates confusion and leads to inappropriate policy responses. Leaders of the European Community in May 1982, for instance, openly criticized Japanese keiretsu and suggested that the six major corporate groupings of Japan (Mitsui, Mitsubishi, Sumitomo, Fuyo or Fuji, Sanwa, Daiichi Kangyo groups) act as barriers to international trade, contributing to the closed nature of the Japanese market. Similarly, the Office of the United States Trade Representative published a comprehensive report on keiretsu in October 1982, basing its conclusions on the premise that horizontal keiretsu known as kigyo shudan were responsible. Other types of industrial groups and especially the vertically linked keiretsu were not mentioned in either of these reports. The chairman of Mitsubishi, Shohei Mimura, recently spoke to this failure to recognize other types of keiretsu. He expressed bewilderment about the attacks on keiretsu by American officials. He observed that there are several types of keiretsu, such as those which link manufacturers and suppliers at the production level, and those manufacturers and dealers which are linked at the distribution level (Nihon Keizai Shimbunsha 1990,
This situation, he stated, reflects little understanding of the various types of keiretsu.

The confusion over how to classify these industrial groups is not only found among governmental officials, but scholars as well. They have attempted to classify them in a number of ways. Czinkota and Woronoff, for example, classify keiretsu into three types: horizontal, vertical, and distribution (Czinkota and Woronoff 1986, 26). Horizontal groups are subdivided into two types: those industrial firms bound together since the World War II era under the control of a few influential families, and those groups of related firms linked to large commercial banks with a particular bank as the dominant member of the group. The vertical keiretsu for these writers means production keiretsu, typically composed of a large manufacturer and its essential parts companies. The distribution keiretsu consist of a manufacturing company and affiliated wholesale and retail distribution outlets (ibid, 21). Most, however, define keiretsu broadly and agree that there are only two levels of these groups: the horizontal and the vertical.

There are a number of different terms used to describe keiretsu despite this agreement. The term financial keiretsu, for example, is used by Aoki to mean a horizontal keiretsu, and the term, capital keiretsu is used to describe a vertical keiretsu (Aoki 1988, 119-120). Other writers use special expressions such as "former zaibatsu" and "kinyu
"keiretsu" to designate horizontal keiretsu (Okimoto 1989, 132-133). Still others apply labels of kinyu (financial) or yushi (financial funding) keiretsu for horizontal keiretsu and sangyo (industrial) or kigyo (enterprise) keiretsu for vertical keiretsu (Bieda 1970, 210). Okumura, for example, uses "kigyo keiretsu" for the vertical keiretsu and "kigyo shudan" for the horizontal keiretsu (Okumura 1985, 201-202). Clearly, one of the problems for the study of these industrial groups is the absence of common terminology.

In the absence of a consensus, this researcher developed a typology of keiretsu principally from works of Japanese scholars. Table 1 analytically explicates the types of keiretsu. Although such a classification has utility for clarifying the confusion surrounding the complexity of these groups, in practice, some firms simply can not be described merely as being in a vertical or horizontal keiretsu. Some firms are both. For example, a manufacturing firm may have vertical ties with its subcontractors and distributors, but it also may be closely related to a horizontal keiretsu gathered around a commercial bank. This phenomenon is described below in Table 2, on page 29.
Table 1. Classification of Keiretsu

<table>
<thead>
<tr>
<th>Types of Keiretsu.</th>
<th>Compositions of Keiretsu.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horizontal Keiretsu or Kigyo Shudan</td>
<td>Former Zaibatsu Groups: Mitsui, Mitsubishi, and Sumitomo.</td>
</tr>
<tr>
<td></td>
<td>Bank-Centered Groups: Fuji (Fuyo), DKB (1), and Sanwa.</td>
</tr>
<tr>
<td>Vertical Keiretsu (2)</td>
<td>Production Keiretsu: A Core Manufacturer/Suppliers of Raw Materials, Parts, and Products (3).</td>
</tr>
<tr>
<td></td>
<td>Distribution Keiretsu: A Core Manufacturer/Suppliers of Raw Materials, Parts, and Products.</td>
</tr>
</tbody>
</table>

Note: (1) DKB= Daiichi Kangyo Bank group.

(2) For the vertical keiretsu the table illustrates only the case of major manufacturer as the core firm although some vertical keiretsu include non-manufacturing firms as the core firm.

(3) Production keiretsu are further subdivided by Fujigane and Ennis into two categories: Industrial keiretsu composed of a large manufacturer and its subsidiaries and production keiretsu composed of a large manufacturer and its independent subcontractors.

Source: compiled by the author from definitions by Aoki (1988); Dodwell Marketing Consultants (1986); Fujigane and Ennis (1990); Gerlach (1989); Haitani (1976); Lawrence (1991); McCrow and O'Brien (1986).

Horizontal and Vertical Keiretsu Relationships

Although there are independent vertical keiretsu, most of the giant vertical keiretsu also belong to a horizontal keiretsu. Thus, the horizontal and vertical keiretsu do not
exist only in parallel form in practice but also in a mixed form. Typically, each giant firm of the kigyo shudan or horizontal keiretsu is affiliated with other independent firms, which have their own vertical keiretsu of independent parts suppliers and distributors. On the other hand, some giant firms of vertical keiretsu also are a part of a horizontal keiretsu through their ties with commercial banks. Close capital and human ties have developed between them and are carefully cultivated in a president's club environment. Toyota Motor Company, for example, interacts with the Mitsui group through hakusui kai, the president's club of the Mitsui group. Some vertical keiretsu, on the other hand, have remained independent from the kigyo shudan. The relationship between the kigyo shudan and vertical keiretsu is illustrated in Table 2.

Table 2 attempts to illustrate the types of relationships between the members of both horizontal and vertical keiretsu. The ties and relationship between members of a horizontal keiretsu are largely on the basis of equality, since the firms are independent each other even though there often is mutual stockholding between them. The relationships along with the social activities of the president's club are shown in (A) of Table 2. In vertical keiretsu, however, the relationships tend to be hierarchically ordered, with the manufacturer on top of either its distributors or subcontractors. The manufacturer
Table 2. Relations of Horizontal Keiretsu with Vertical Keiretsu

(A) Horizontal Keiretsu
(Kigyo Shudan)

(B) Ties of Horizontal Keiretsu with Vertical Keiretsu

Note: The shape of the groups designates the type of keiretsu. The larger circles represent firms which are a part of kigyo shudan or horizontal keiretsu. Vertical keiretsu are shown in (B) as dotted triangles with small circles to represent member firms.

- Indicates kigyo shudan or horizontal keiretsu.
- Designates vertical keiretsu.
- Means large firms: banks, trading firms, and manufacturers.
- Shows subsidiaries and subcontractors.
- Indicates the mutual stock holding between the member firms in a horizontal keiretsu.
- Indicates unilateral stock holding between a large manufacturer and the firms with its vertical keiretsu.

The rectangle around member firms of vertical keiretsu represents cooperative associations. In horizontal keiretsu the rectangle with x in it represents the President's club.

Source: Adapted from Sakamoto and Shimotani 1989, 4.
Although mutual holding of stocks may occur in the vertical keiretsu, this is usually the exception, and ownership of stock normally is in a unilateral manner with the dominant manufacturer owning a share of the subcontractors or distributors. Relations among keiretsu tend to be continuous although they are constantly modified in composition due to internal and external reasons. Finally, the table attempts to show the special social relations which are developed by the president's clubs and the cooperative associations.

Contrasts among Four Types of Industrial Groups:

Keiretsu, Networks, Conglomerates, and Zaibatsu

There are at least four distinct types of industrial groups: keiretsu, networks, conglomerates, and zaibatsu. Zaibatsu, or financial cliques of business conglomerates under the control of a few families, were the dominant type of industrial groups before World War II. These were broken up by the war and subsequent military occupation and are no longer found in the same form. Many of these zaibatsu have been reconstituted as horizontal keiretsu, and it is important to understand them.

Although keiretsu are broadly defined as groupings of two or more legally independent companies, they can be differentiated from both a network of companies and conglomerates. For the purpose of this dissertation, a
Keiretsu involves special institutional arrangements between legally independent companies, such as intercorporate shareholding of a group of companies, inter-directorships, or other special relationships between them. A network of independent companies, on the other hand, involves connections between firms without such formal institutional arrangements. This network of firms is not necessarily keiretsu.

Keiretsu also can be differentiated from conglomerates. A conglomerate is a business corporation formed by the acquisition of other firms (Encyclopedia Britannica 1991, 533). They are composed of a holding or owner firm which almost totally controls the entire business, and they are found most frequently in general trading firms, such as Mitsui & Company, Marubeni Company, Mitsubishi Shoji Company, and Ito & Company. Keiretsu are affiliations of independent firms not under the control of a single holding or owner firm. Despite this apparent difference between keiretsu and conglomerates, some writers treat keiretsu as conglomerates. For example, keiretsu are defined by Johnson (1982, 12) as the "oligopolistic organization of each industry by a conglomerate." Similarly Imai (1982, 57) speaks of the descendants of zaibatsu or horizontal keiretsu as the "traditional conglomerate group."

Despite this confusion, there are major differences between keiretsu and conglomerates. While a conglomerate
may vertically integrate related business firms by creating different divisions of the company, firms in keiretsu are only vertically affiliated. They do not become a vertically integrated firm, but remain independent firms. "Vertical affiliation" is different from "vertical integration" according to Nakatani (1990, 162). Vertical integration implies internalization of business transactions and decisions under the dominant firm's control, whereas vertical affiliation occurs where member firms still possess a degree of autonomy and no single controlling firm exists. Leadership in vertical affiliations must be through cooperation, whereas in a vertical integration it is a purely hierarchical control.

Table 3 contrasts keiretsu, networks, conglomerates, and zaibatsu. Each of the these kinds of industrial relationships affects the political economy of Japan in a different fashion.

Keiretsu also may be differentiated from zaibatsu, although both share a number of similar features. The zaibatsu, or literally financial cliques, are controlled by a few families" (Chang 1981, 8). Management of the business firms under the zaibatsu were entirely in the hands of members of the family until World War II. The devastation of war and reconstruction brought down many of these powerful families, and the firms were dissolved by the occupying forces. Once the occupying forces left the
country, however, many of these firms resumed business, often under the leadership of former middle managers who now created horizontal and vertical keiretsu to secure business relations.

Table 3. Contrasts between Keiretsu, Networks, Conglomerates, and Zaibatsu

(A). Keiretsu consist of independent firms, but they are linked by some formal institutional and informal social arrangements.

- designates horizontal keiretsu.
- shows vertical keiretsu.
- indicates large firm.
- means subcontractors or subsidiaries.

(B). Networks are a form of linkage of independent firms because of mutual interests or benefits.

- indicates independent firm. Relationship in a
network may be continuous or only occasional or infrequent.

(C). In a conglomerate, a large company incorporates former independent companies in related or non-related business field through mergers and acquisitions.

- is a conglomerate company.
- means business division.
- is a business subdivision.

(D). Zaibatsu, ①, means a family company owning various types of business firms, ②, ③, ④, ⑤ etc.

Source: Constructed by the author from definitions found in Futatsugi 1986; Gerlach 1992; Negishi et al. 1990; Okumura 1990, 92; Sakai 1965, 28; Sakamoto and Shimotani 1989.

Before World War II, many types of zaibatsu, including "sogo zaibatsu" or "all-embracing zaibatsu" which were industrial cliques of both financial and industrial firms existed. An example was the Mitsui zaibatsu, one of the country's largest family-controlled enterprises, which was involved in banking, shipbuilding, chemicals and number of other industrial fields. A second type was a "kinyu zaibatsu" or "financial zaibatsu" in which the group was centered around a major bank. An example of this type zaibatsu includes Yasuda which was a family owned banking and finance company. A third type of family owned enterprises was called "Kigyo zaibatsu" or "industrial zaibatsu." In these companies the family controls a number of major industries (Nippon steel Human Resource Development 1988, 95-97). The Mitsubishi zaibatsu was an example of a family-dominated company of major industries. It dealt with such industries as shipbuilding, aircraft construction,
steel, and real estate.

All of these former zaibatsu shared a number of common features: (1). the shares of member firms were held by a single holding company which was under the reign of a single family. Their assets were the family’s money; (2). the holding company had absolute controlling power over management and employment in the member firms; (3). strong links were maintained between the zaibatsu and political parties (ibid, 97), and they largely shaped the countries’s economic and trade policies.

Similarities between zaibatsu and keiretsu are found in keiretsu even today, such as the interlocking directorates and the system of intragroup trading through a general trading firm even though zaibatsu were formally broken up by the occupation forces of the allies.

Major differences also exist between contemporary keiretsu and former zaibatsu. There is no family holding company in contemporary keiretsu such as there was in zaibatsu. Financing of the group firms in today’s keiretsu generally is provided by either member banks or trading firms for horizontal keiretsu, whereas the family in zaibatsu provided financing for the family holding company. The pattern of owning stocks by a member firm is also different between keiretsu and zaibatsu. Zaibatsu were solely family owned through a holding company, and therefore there was no stock mutually owned between firms in the
zaibatsu (Futatsugi 1986, 45). In horizontal keiretsu there is no formal holding company, and mutual stockholding between the member firms is quite common. For instance, stocks are mutually owned between Toyota Motor Company and Mitsui bank, as well as between Mitsubishi heavy industry and Mitsubishi bank (Tsuda 1980, 6-7).

The practice of interlocking stockholding began after World War II to deter "hostile takeovers" from other domestic firms upon dissolution of the zaibatsu. As the zaibatsu were being dismantled, they asked friendly firms to buy their stocks as a means of ensuring support should they be subject to a hostile takeover. Interlocking shareholding also was used to prevent a foreign takeover upon relaxation of incoming foreign capital into Japan (Imai 1990, 26). Today interlocking share holding may be used to promote business coordination, mutual ties, and possible profitable operations (ibid).

Another difference between zaibatsu and keiretsu is that the former zaibatsu had a specific business emphasis or domain. For instance, the emphasis of industries for the Sumitomo zaibatsu was metal processing, and for the Mitsui zaibatsu, it was shipping and machinery. This is not true in today's keiretsu. The horizontal keiretsu, instead of limiting itself to one or two major business fields, are involved in a number of industries since they follow the practice of "one-setism" (Futatsugi 1986, 56). The practice
of "one-setism" by a horizontal keiretsu may be defined as where a horizontal keiretsu has at least one firm of the various types of firms within the group, but each of the firms has a vertical keiretsu set under it. For instance a horizontal keiretsu enters into numerous fields and typically has at least one commercial bank, one trading firm, and various industrial firms such as chemical, shipping, electronics, and automobiles. Under each of these firms are clustered firms of a vertical keiretsu. This type of organization provides support for each of the segments and gives a sense of comprehensiveness to the entire group. For example, each horizontal keiretsu, such as Mitsui, Mitsubishi, and Sumitomo, is engaged in almost all industrial sectors. Every horizontal group has also entered into new industries such as nuclear energy and oil exploration, etc. (ibid, 63) through their vertical keiretsu firms.

Furthermore, keiretsu are not as cohesive as the former zaibatsu which were dominated by a ruling family. However, there has been a major debate about the degree of cohesiveness of the horizontal keiretsu. Most see the keiretsu as weak in cohesiveness or closeness of the grouping. They stress a diffused pattern of intercorporate share-holding and a lack of a central command center. Others, such as Okumura (1985, 196) and Bieda (1970, 218-219) stress effective control of member firms by collective
arrangements of keiretsu such as presidential councils or president's clubs. This controversy is discussed further in a later section of this chapter.

Causes for the Development of Keiretsu

The literature identifies three causes for the development of keiretsu: economic, cultural, and legal. It should be noted that except for the legal factors, writers on keiretsu generally do not emphasize the influence of political factors in the development of these groups. This study, however, examines how political variables influenced the emergence of keiretsu.

Economic factors

Economic explanations hold that keiretsu are reflections of economic developmental patterns. There have been major debates among Japanese scholars as to whether the vertical keiretsu is a "higher stage" of the prewar "subcontracting system" of zaibatsu (Shinohara 1968, 18) since it appears to be essentially the same arrangement with minor modification according to Kobayashi (1958).

Others, including Fujita (1954), dispute this theory of evolution of the vertical keiretsu and argue that these industrial groupings developed entirely during the post war period as a result of the rapid growth in the industrial sector. Later, as these arrangements demonstrated their
value, vertical keiretsu were formed in the expanding non-manufacturing sectors such as supermarkets and department stores. Those who take the position that vertical keiretsu are not a higher stage of the prewar subcontracting system stress that vertical keiretsu were created either to take advantage of cheap labor of subcontractors or to pursue rationalization of the "production process of their subordinate enterprises" (Shinohara 1968, 17). Although vertical keiretsu appear to be somewhat similar to earlier subcontracting arrangements, it is contended that there is no historical tie between them.

Still others argue that vertical keiretsu have developed as a reaction to the practice of "one setism" adopted by horizontal keiretsu in the postwar period, i.e., the practice of having at least one firm of the horizontal keiretsu representing various sectors of the economy (Futatsugi 1986, 60). This practice, it is believed, encourages vertical keiretsu under each firm as a means of competing with other horizontal keiretsu. Others suggest, however, that the formation of vertical keiretsu occurred independently of horizontal keiretsu in the post-war period. These scholars reason that large manufacturers needed vertical keiretsu in order to consolidate the less developed manufacturing and distribution sectors in face of international competition during the mid 1950 and 1960s.

Postwar economic conditions, in fact, are identified by
a number of scholars as the cause for the formation of keiretsu. The rapid economic growth in the mid-1950s and the early 1960s, according to Imai (1982, 57), facilitated the emergence of a loosely linked kigyo shudan (horizontal keiretsu). The favorable conditions of economic growth after the war and reconstruction encouraged new industrial firms to adopt some of the practices of former zaibatsu. Creation of these new industrial groups (keiretsu) enabled these firms to coordinate their businesses through mutual information exchange and to contain and resolve potential conflicts between them so that all could share the benefits of economic growth.

The downturn and economic uncertainty in the mid-1960s, according to Imai, seriously challenged these fledgling industrial groupings (Imai 1982, 57). The profit level of horizontal keiretsu declined in this period, since there was not enough business to support all firms (ibid). In this economic climate, they could not assume economic leadership and benefit from their closeness and ability to exchange information (ibid). Independent industrial companies, in fact, were better able to flourish during the periods of economic decline (ibid, 56-57) since they could more easily adjust to competition and also since they could more easily lay off surplus personnel than keiretsu firms. The average annual profit level of firms in horizontal industrial groups was compared by Imai with independent firms from 1900 to
1965. He found that horizontal keiretsu flourished in good times but tended to decline during the time of economic downturns (ibid, 57).

Similarly, horizontal keiretsu groups were found by Roehl to have been created in response to specific economic incentives of Japan in the late 1950s, such as high economic growth, the availability of foreign technology, and the formal or informal governmental support provided to firms in this period (Roehl 1983, 3). He also compared stock prices of firms in horizontal keiretsu with those of independent firms in this period. He reported that stock prices of firms in keiretsu exceed those of independent firms, indicating that being in a keiretsu was favored by those purchasing stocks.

These studies tend to disregard the influences of non-economic factors, such as legal and cultural matters. Neither do they explain why prosperous times encourage firms in keiretsu rather than independent firms. Although they show what has transpired, they do not adequately explain why.

Cultural Factors

The formation of corporate groupings (keiretsu) according to other observers is attributed to the culture which evolves from the group mentality of Japanese people or the group-oriented culture of Japan. These writers
typically argue that group behavior is rooted in the culture of Japan. The historical family spirit of a pre-modern Japanese community or village, where cooperation was essential to keep and ensure the operation of the "irrigation and drainage system of paddy field agriculture," is the basis of this culture (Frost 1987, 67-68). The group orientation of the Japanese people, according to Frost (1987, 67), is stronger than any other society. This is seen especially in the "small, immediate, ingroups" and affects people especially in the work environment. It even has been argued that the group orientation leads to the formation of a corporate network or keiretsu in the business sector (Frost 1987, 67). The basic motivation of forming keiretsu, according to this reasoning, is the inheritance of the Japanese "cultural tradition," stressing a "group oriented society" where everyone has his or her place, as in a family (Haitani 1976, 124).

The Japanese, according to Bradley (1984, 112-114), are culturally attached to small groups such as the family, school, and company. Unlike the West, where individualism encourages attachment to universal values such as equality and justice, Japanese are attached to groups. This cultural difference grows out of the cultural pattern of the "village community" or "mura kyodai" in historical Japan (ibid, 4). The mentality of the village community, he suggests, promotes intra-group harmony, but permits inter-group
diversity and competition, since the inter-group competition does not violate the ties within the group. The pattern of societal behavior in Japan, therefore, he asserts, can be understood neither in the control of the bureaucratic elite model, where bureaucrats dominate the society, nor in the pluralistic competitive model, which suggests inter-group competition but ignores the ties and harmony among groups. The key to understanding societal behavior in Japan, according to Bradley, is found in the mentality of the village community (ibid).

Bradley's conceptualization of Japanese behavior, however, does not explain the inter-corporate cooperation within keiretsu. It is difficult to explain the cooperation among large and diverse firms in a horizontal keiretsu with his conceptualization of a small community or group mentality. The concept remains vague about the boundary of the small community; how far can it be extended to explain intra-corporate relations, such as cooperative associations of suppliers for a large manufacturer in vertical keiretsu, or inter-corporate relation among horizontal keiretsu? Furthermore, not all firms belong to a keiretsu. Many small, medium, and some large firms remain independent. Many of these do not reflect the group orientation described by Bradley. The amount of group cohesiveness within a firm also varies from firm to firm. This approach has not been able to explain why groupings are more extensive in large
companies rather than in smaller corporations. Neither do they explain why people’s spirit of cooperation and loyalty does not extend to other enterprises.

Okumura (1985, 27-28), questions why the spirit of family and community or village infuses harmony and group cohesiveness in one type of organization but is absent in other types of organizations, such as labor unions, political parties, and schools, which are not necessarily harmonious (ibid, 28). He argues that intercorporate relations are more multifarious than person-to-person relations, and thus the logic of person to person relationships can not be applied to a company’s relations with other companies (ibid, 226-227). Inter-corporate relations can not be explained by the logic used for individual relations, although a company consists of a group of people (ibid, 226). The cultural approaches may end up focusing on the behavior of Japanese people rather than on corporations (ibid, 28). Inter-corporate ties, such as keiretsu, appears to be more institutionalized than that of individual ties since various laws and regulations about inter-corporate relations create different patterns of inter-company relationships (ibid, 226-227).

**Legal and Institutional Framework**

Some argue that the legal institutional arrangements in Japan make keiretsu possible and that these arrangements
help create keiretsu. For example, Okumura (1982, 34) finds that the keiretsu groupings were greatly influenced by government's rules and regulations. The legal and institutional framework of companies is considered to be more important in their formations than considerations of the cultural and human relations among Japanese (Okumura 1985, 226-227). Cultural features are reflected in the framework of keiretsu, but Okumura insists that the institutional framework of Japanese firms are a more significant cause for the development of industrial relationships (ibid, 226). Keiretsu are strengthened by the institutional arrangements, such as intercorporate shareholding, group financing, and interlocking directorships, all permitted by laws and regulations in Japan (Okumura 1982, 34). He points out that banks in the United States are prohibited from owning stocks in other companies, whereas in Japan banks are allowed to own stocks of other firms as long as the ownership does not exceed a certain limit (ibid). The legal and institutional differences between the United States and Japan prevents the rise of such industrial groups in the United States and encourages them in Japan.

All of the above factors—economic, cultural, and legal and institutional—may contribute to the formation of keiretsu. Although the explanation used by those emphasizing legal and institutional factor touches on some
political aspect, the political arrangements and the nature of politics in Japan as a cause for these groups are not fully covered. The author of this study views politics as an important factor influencing the development of keiretsu and examines how these groups are involved in politics.

The phenomenon of zaibatsu and the subcontracting system in prewar times was rooted in the political system. The Japanese government, especially the military government, had fostered cooperation between a few large manufacturing firms and a large number of small companies as subcontractors in order to rapidly industrialize the economy and to cope with military requirements for heavy machinery and equipment. Even after the war, the government, especially ministries of economic affairs, such as the Ministry of International Trade and Industry and the Ministry of Finance, took a pro-business position and largely ignored the concerns of consumers' interests. For instance, the concept of anti-monopoly or antitrust laws was virtually non-existent in the pre-war period. The reconstruction government of the United States after the war did not strictly enforce anti-monopoly, even though anti-monopoly measures similar to American laws were enacted soon after the war. After the end of the Occupation, the economic ministries tended to encourage firms to form oligopolistic corporations through mergers or subcontracting ties between a large manufacturing firm and small companies
in order to enable them to compete with foreign companies. Government financial assistance also was made available through government financial institutions, and consolidation efforts in the business sector were encouraged. These political factors cannot be ignored since they helped create favorable conditions for Japanese firms, especially large firms, to create both horizontal and vertical keiretsu.

This study contends that the development of both types of keiretsu, horizontal and vertical, date back to the prewar period. For the horizontal keiretsu, some features of zaibatsu, such as interlocking directorships and intragroup trade through general trading firms of the group, continued to evolve with government support. Major features of postwar vertical keiretsu, such as the subcontracting system and the exchange of management personnel with its affiliate firms, were used in the prewar industrial grouping (kigyo zaibatsu) in which the group centers around a major industry. The foundation of most postwar industries, such as textile, machines, and chemicals, were created earlier in the prewar period and incorporated many of the practices used by the kigyo zaibatsu. After the war these firms continued these practices as they evolved into vertical keiretsu.

The basic structure of the Japanese economy since the Meiji Restoration (1868) consisted both of large number of traditional labor intensive small and medium sized
enterprises and a small number of capital intensive large companies. This dual structure of Japanese enterprises provided a basis for the formation of zaibatsu and keiretsu. Thus, keiretsu must be viewed in terms of an evolutionary pattern extending from the prewar period. Similarities in the institutional arrangements of both zaibatsu and keiretsu further support this position.

Why They were Created

Review of the literature identifies several purposes that keiretsu were created, including profit maximization, insurance or risk avoidance, and risk taking or strategic caretaking reasons.

Profit Maximization

Most economists regard keiretsu as intermediate organizations which promote profit maximization by standing between independent firms and the market. The intermediate organizations or keiretsu are organized to minimize costs of business transaction and expansion. Odagiri (1975, 145-154) suggests that corporate groupings are able to reduce costs of business through mutual exchange of business, services, and information, resulting in the more effective use of the resources of production of firms within the group (Aoki 1987, 279-280). A problem with this profit maximization theory, however, is that it is very difficult to explain the
continued existence of independent, competitive companies alongside keiretsu firms. If the motivation of the groupings is only to reduce transactional costs of member firms and to maximize profits (ibid), why or how can independent competitors do as well as firms within the industrial groups?

Insurance and Risk Avoidance Functions

Some Japanese observers suggest that the risk avoidance function is more significant to keiretsu firms than it is to non-keiretsu companies. Aoki, for example, found that average tenure of employees of keiretsu firms was longer than that of independent companies, and thus keiretsu companies have more of a burden because of the guarantee of permanent employment to their employees (Aoki 1988, 233-234). The personnel practices of keiretsu firms where employees are considered to be members of the family and not subject to being laid off or terminated without major causes prevent these firms from reducing excessive personnel as easily or quickly as independent firms. This makes them much more concerned with risk avoidance. Furthermore, managers of keiretsu firms are largely "career-salaried managers" who tend to avoid risks which might injure their career path opportunities, while independent firms often are managed by entrepreneurs who are more willing to take risks (ibid).
Some empirical works, such as those of Caves and Uekusa (1976), have compared profit levels between keiretsu firms and large independent companies from 1961 to 1970. They found that the profit levels of the independent companies were higher than those of keiretsu firms. Similarly, Nakatani (1984, 227-258) found in his empirical study which compared 317 nonfinancial keiretsu firms with independent companies from 1960 to 1974 that the profit levels of keiretsu firms were from 1.1 to 2.7 percent less than the profits of independent firms. He pointed out that although the average profit ratio of nonfinancial keiretsu companies is lower than independent companies, their business performance is more stable than that of independent companies (Nakatani 1990, 155). He reported that keiretsu member firms were more likely during times of difficulties to receive financial and managerial help from banks because of the closeness between member banks and affiliated companies (ibid). This phenomenon he called the insurance function of keiretsu since it serves as a business stabilization function. Member banks of keiretsu, according to Haitani (1976, 125), Caves and Uekusa (1976, 67-68) and Nakatani (1990, 155-156) were more willing to help firms in keiretsu during financial crises than independent firms. It appears that keiretsu organizations are not merely concerned with cost, but also with long term business stability in an uncertain economic environment. From the findings
pertaining to the stability of keiretsu firms, Nakatani draws the conclusion that firms may become members of keiretsu to benefit from this insurance function. This view has been shared by others, including Prestowitz (1988, 164), and Okimoto (1989, 138-140).

Nakatani's conclusions (1984), however, are not free from criticisms. First, the study covered only the period from 1960 to 1974 and did not examine the period of the 1950s when economic growth was taking place and profits of keiretsu firms exceeded non-keiretsu firms. He also disregarded non-economic factors, such as legal, political, and historical variables. The initial economic incentives in the 1950s caused by economic growth and availability of foreign technology, as well as formal or informal government support of firms, according to Roehl (1983, 346), made the group of affiliated firms more profitable than independent firms in that period. Furthermore, group affiliated companies were given preferential treatment from the Japanese government in the 1950s and early 1960s since access to foreign raw materials and foreign patents were rationed by government according to market shares of products of firms, which favored keiretsu firms. In the mid 1960s, however, he found that as a result of low economic growth, profits to group firms were lower than independent firms since they were slower to adjust to the economic downturn (ibid, 346-347). Only in the period of economic
downturn did the risk avoidance factor become a major aspect of keiretsu.

Hadley also raised a methodological concern about Nakatani's study. She questioned the validity of Nakatani's inclusion of Sony and Toyota in the Mitsui group, Honda in the Mitsubishi group, and Matsushita in the Sumitomo group (Hadley 1984, 321). His methodology, it was claimed, permits confusion over whether or not various firms belong to a keiretsu. The inclusion of firms into keiretsu members simply because they are members of the president's club, observers such as Miwa (1990), Okimoto (1989, 146) and Hadley (1984) contend, do not automatically indicate that the firm is a cohesive member of the group.

Risk Taking or Strategic Function

Nakatani recently stated that keiretsu permit firms to take greater risks in business, and that these groups serve a risk-taking function in horizontal keiretsu (Nakatani 1990, 160). Keiretsu firms are insulated from some business pressures, such as obtaining funds to finance new additions or programs from "capital markets" because of their group membership and the ability of financing such needs from the group (ibid). Because of the keiretsu network, individual firms can take greater risk in long term planning and in undertaking research and development activities to support such projects.
Vertical keiretsu, Nakatani found, are even more willing to take risks than horizontal keiretsu. The system of the vertical keiretsu encourages an efficient and flexible mode of production between a parent manufacturer and its subsidiaries or subcontractors (ibid, 161). The ties between manufacturers and its subcontracting firms within a keiretsu permit the subcontracting firms to assume additional roles as a substitute to internal diversification of the parent company (Okimoto 1989, 125; Okumura 1985, 201-203). The purpose of the parent manufacturer is to increase management efficiency by separating some divisions of the firm into independent subsidiary or subcontracting firms.

Long-term and risk taking strategies for keiretsu firms are possible because of the promotion of the "free flow of information," coordination of production schedules, and technological dissemination between the firms (Fujigane and Ennis 1990, 28). "Risk-sharing" and "strategic alliances" are the essence of Keiretsu in general (Ohmae et al. 1990, 196). Ohmae argues that this pattern of risk sharing and strategic cooperation of keiretsu member firms became an international pattern when Japanese manufacturers began overseas operations of plants (ibid). The pattern, however, does not necessarily mean the formation of keiretsu by Japanese firms with Western firms just because of internationalization of business (ibid). These practices which enable firms to take greater risks in their
operations, it is argued, are one reason why firms prefer to become a member in a keiretsu.

Influence of Keiretsu on Member Firms and Their Impact on the Internal and External Economy

Three conflicting views on the influence of the horizontal keiretsu (kigyo shudan) on firms in the group and their impact on the domestic and international economy exist. One view holds that the influence of the keiretsu on member firms and the economy are either nonexistent or negligible at the most. A second view contends that horizontal keiretsu significantly influence member firms and have a great impact on the domestic and foreign economy. A third view suggests that keiretsu influence is only moderate.

The view that keiretsu have no major impact on the domestic and foreign economy is held by such writers as Caves and Uekusa (1976, 67-68), Hadley (1970, 219-246), and Miwa (1990, 176-177). These scholars contend that ownership of stocks by the keiretsu bank or general trading company of a horizontal keiretsu is so small that the keiretsu has little power over its member firms. Their argument is supported by Miwa (1990) and most business leaders of Japan who hold that there is no significant impact of the kigyo shudan on the Japanese economy, let alone the international economy. They contend that business initiatives such as
investment decisions are made by managers of each individual firm rather than by the group. Furthermore, they pointed out that mutual share-holdings by firms is now limited by the anti-monopoly law of Japan (ibid).

These writers also contend that the formation of a president's club of each kigyo shudan is solely to promote friendship of the presidents of member firms, and that these clubs have no influence in the decisions of their respective firms (Miwa 1990, 177-178; Rafu Shimpo April 6, 1992, 1; Yoshitomi 1990, 10). Miwa (1990, 196-197) further asserts that many studies of horizontal keiretsu do not ask the most significant questions, such as what is the composition of horizontal keiretsu, the significance of the president's club on member firms, and the differences between the keiretsu and non-keiretsu firms. He contends that those who assert that kigyo shudan exert an influence on the economy fail to ask the preceding significant questions and draw conclusions from inadequate research (ibid, 211-212). Therefore, their conclusions are largely meaningless (ibid).

The perspective contending that horizontal keiretsu significantly influences both members of the group and the economy, including international trade, is held by Kester (1991, 69), Okumura (1985), and Prestowitz (1988, 159). They hold that president's clubs, such as hakusui kai for Mitsui, play a decisive and substantive role in business decisions of firms in the horizontal keiretsu group.
Members of a president's club make the economic, social, and political strategy for the group collectively through coordination, information exchange, and consultation (Okumura 1985; The Oriental Economist 1975, 6-7; Prestowitz 1988, 159). Okumura (1985, 195-196), for example, finds that a president's club collectively acts as the binding power for the member firms. The extent of the power of the presidents is shown by the fact that the president of a member firm may be forced to resign by a collective decision of the president's club if he is involved in a scandal or misconduct in management of his company or simply is out of step with other presidents in the club (ibid, 196).

The apparent power of the president's clubs also can be inferred from decisions of the Sumitomo group to rescue Mazda Motor Company during its financial crisis in the 1970s. The firms belonging to the president's club campaigned to have members of the keiretsu group buy Mazda cars as a means of saving it from bankruptcy. Furthermore, the power of the president's club can be seen in the case of the Mitsui group's decision to fire the president of Mitsukoshi Department Store. These examples show the impact of the president's club on individual group members. The impact appears to be collective, especially when a member firm is having difficulty (Asano 1987, 54).

Horizontal keiretsu significantly influence member firms and the economy through intercorporate share-holding
of firms in the group, and this joint ownership provides an
effective means of disciplining the member companies (Aoki
1987, 279; Lincoln 1988, 56-64; Maruyama 1992, 198; Okumura
1982, 32-35; 1985, 60-65). Proponents of this view also
argue that mutual share-holding insulates group companies
from takeover bids from non-group firms, either of Japanese
or foreign origin. Although the amount of stock held in
other member firms by a single affiliated firm is usually
not very large, collectively the keiretsu holds enough
stock, between 10 and 20 percent, to enable to it to
discipline or protect member companies (Aoki 1987, 279;
Maruyama 1992, 192; Okumura 1985, 195-196). Intercorporate
relations tend to be permanent and cohesive as a result of
the mutual share-holding of stocks of corporations in
keiretsu (Okumura 1985, 177-178). Another means of control
over member firms by the keiretsu comes from inter-
directorships within the kigyo shudan.

The third position about the impact of horizontal
keiretsu on firms in the keiretsu and the economy is that
they have only a moderate amount of influence over firms and
the economy. Its proponents find that control of group
firms by the horizontal keiretsu and its impact on the
domestic and foreign economy is extensive only in certain
industries (Czinkota and Woronoff 1986, 33). Its impact is
greater in industries such as metals, rubber, petroleum, and
chemicals, but for the entire economy the average ratio of
market concentration by the horizontal keiretsu is not large. Unlike the prewar zaibatsu, according to Okimoto (1989, 146), the horizontal keiretsu firms, especially the bank groups of Sanwa, Daiichi Kangyo Bank, and Fuji are only a loose alliance and they are by no means monopolistic. The impact of horizontal keiretsu on the internal and external economy, if any, are considered to be modest according to these scholars (ibid).

There is much less written about the impact of vertical keiretsu on the member firms and the internal and external economy of the country. Most of the literature in this area focuses on either the uniqueness and effectiveness or the benefits of keiretsu. They typically find that risk sharing and technology in the keiretsu group contributes to growth of production, control of quality, and the use of long-term business plans. Keiretsu also enable groups to use effective production practices such as the "kanban system" or a delivery system which provides needed materials "just in time" so that the company can carry a small inventory until the material is essential (Uekusa 1987, 500). Vertical keiretsu also are considered to be a means for sharing technology and improving production as well as a means of reducing risks and costs, which in turn help to absorb shocks of the economic environment (Aoki 1987, 283-288; Okimoto 1989, 130; Prestowitz 1988, 165-166). Aoki (1987, 288), for example, stresses that the Japanese
structure of vertical keiretsu promotes a "self-enforcing discipline" which promotes cost reduction and quality control better than the "in-house division" type of manufacturing in the United States.

Other observers argue that belonging to a vertical keiretsu also entails costs to member firms. Okimoto (1989, 140) believes that the benefits of vertical keiretsu derived from effective coordination and cooperation must be offset against the costs arising from the monopolistic character of vertical keiretsu. Vertical keiretsu are likely to incorporate collusive arrangements within the structure such as price fixing of goods, protection of inefficient companies, and facilitation of oligopolistic actions to control the market (Caves and Uekusa 1976, 58; Okimoto 1989, 140). Abuse of monopolistic control powers by parent firms in the keiretsu occurs occasionally although the Japanese government enacted the subcontractor's protection law in 1956 (Uekusa 1987, 505). The law encourages subcontractors to have written contracts with their parent firms and prohibits certain kinds of abuse of power by parent companies. The law intended to prevent parent companies from delaying payments, enforcing lower prices of goods supplied by the subcontractors, and forcing subcontractors to purchase products of their parent company. After the first oil crisis of 1974, Uekusa (1987, 505) found that violations of this law increased and did not decrease until
1978. The second oil crisis of 1979 again led to violations of this law and to abuses by the parent firms of their subcontractors (ibid). Competitive industries such as "general machinery" and electronics were found to violate the law more than other types of industries (ibid).

Still other observers argue that the system of vertical keiretsu makes it difficult for those outside the system to do business with the keiretsu. The system of vertical keiretsu, according to Czinkota and Woronoff (1986), is closely integrated through various means such as "presidential councils" and associations of suppliers and subcontractors created by manufacturers. The relationship between manufacturers and suppliers is much closer in Japan than in the United States, according to Lincoln (1990, 89). Lincoln (ibid) believes that the relationship between the parent firm and subcontractors is strengthened by the fact that the parent company finances the subcontracting suppliers. In addition, these relations are strengthened by the practice of transferring retired personnel of the manufacturing firm to the subcontracting firms in order to reduce the financial burdens of the parent company resulting from the life-time employment practice of large keiretsu firms. In the distribution sector of vertical keiretsu, according to Czinkota and Woronoff (1986, 55), it is even more difficult for outsiders to gain access since manufacturers usually designate wholesalers and retailers to
sell their products. While there appears to be little
discrimination based on origin of products or nationality of
products (Czinkota and Woronoff 1986, 62), this keiretsu
distribution outlets effectively prevents non-keiretsu
firms, either Japanese or foreign firms, to enter the market
since the manufacturers substantially control the
distribution outlets.

Summary

The literature review suggests that there are various
types of keiretsu and that there is a lack of agreement as
to the definition of these groups. Keiretsu often are
categorized as horizontal or vertical, although in practice
the two are mostly intertwined. Usually, keiretsu are
broadly defined as two or more independent firms linked to
each other by special institutional arrangements such as
mutual or unilateral stock holdings, subcontractors'
relationships, and an interchange of directorships. Social
clubs, such as the president's clubs for horizontal keiretsu
and cooperative suppliers' associations for vertical
keiretsu, are a vital part of these industrial groupings.

Keiretsu may be differentiated from networks, zaibatsu,
and conglomerates. Keiretsu are neither mere networks of
information exchange nor systems of family control of member
firms as in zaibatsu. They differ also from conglomerates.
Unlike conglomerates, they are not integrated into various
divisions of business under a large firms. Each firm remains independent legally but connects to other firms in industrial groups either horizontally or vertically.

Although the literature identifies four causal factors in the development of keiretsu, namely the economic, cultural, historical and legal factors, little attention has been given to political variables. Furthermore, most literature treats keiretsu as only a post World War II phenomenon. This study holds that horizontal and vertical keiretsu are rooted in the pre-war period.

Several purposes of keiretsu have been suggested based on both empirical and non-empirical studies. Among the purposes for joining keiretsu, researchers normally include profit maximization, insurance or risk avoidance, and risk taking reasons. As persuasive as these writers are in advancing their particular emphases, clearly there is no single reason why firms join in keiretsu.

Three conflicting views have been suggested in the literature about the influence of the horizontal keiretsu on member firms and their impact on the domestic and foreign economy. These views vary from stating that horizontal keiretsu have a significant impact to little or no impact on the member firms or the domestic and international economy. Similarly, writers disagree as to the impact of the vertical keiretsu on member firms and the internal and external economies.
Although the literature on the impact of vertical keiretsu on member firms and the domestic and foreign economies is limited, the impact of these group on member firms and the economies appear to be more direct and intense than horizontal keiretsu. The hierarchical relationship and structure of vertical keiretsu gives the parent firms great power over other member firms.

To gain greater insights into the role of vertical keiretsu and their impact on the domestic and foreign economy, this study undertakes case studies of the Japanese automobile and consumer electronics industries in the following chapters.
CHAPTER III

VERTICAL KEIRETSU IN AUTOMOBILE PRODUCTION

The purpose of this study is to explore the organization of industrial keiretsu and to evaluate the impact they have on governmental policies including bilateral trade relations between Japan and the United States. To this end, two major keiretsu were selected for case studies. The Japanese automobile production and distribution keiretsu will be studied in chapters III and IV. The next chapter, chapter V, examines those in the electronic industry.

This chapter examines the automobile production keiretsu, their development, costs and benefits to the domestic and foreign economy, and their transformation as a result of political and economic pressures from the internal and external environment. Automobile distribution keiretsu are similarly studied in the following chapter.

Automobile Production Keiretsu

Production keiretsu in the automobile industry have several distinguishing structural features. They constitute a system whereby automobile manufacturers are closely tied with legally independent suppliers of automobile parts. This relationship results in a low ratio of in-house
operations for manufacturing parts by the automobile makers (Dodwell Marketing Consultants 1986; Matsui 1988, 49; McCrow and O'Brien 1986, 81; Mitsubishi Research Institute 1987, 3).

The Japanese automobile manufacturing system, as a result, differs from the American system of car manufacturing wherein a large portion of the automobile parts are produced by the automobile makers themselves. Instead, Japanese automobile makers act as "planners, assemblers and marketers" of automobiles, since much of the production work of parts and component is undertaken by automobile parts suppliers within the production keiretsu (Pascale and Rohlen 1983, 225).

Over 70 percent of automobile parts in Japanese automobile manufacturing are bought from independent suppliers (Minato 1989, 5; Mitsubishi Research Institute 1987, 3). In the United States, on the other hand, automakers produce most of the parts in-house, buying only about 30 to 50 percent of parts from independent suppliers (McCrow and O'Brien, 1986). The difference between Japanese and United States automobile makers in the ratio of in-house production of automobile parts is illustrated in Table 4, contrasting the organization of Toyota and General Motors (G.M.).
Table 4. Production Pattern: Japanese and U.S. Auto-makers

<table>
<thead>
<tr>
<th>Related parts industries</th>
<th>&quot;A&quot; company in Japan</th>
<th>&quot;B&quot; company in U.S.A.</th>
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<tbody>
<tr>
<td>Primary subcontracts</td>
<td>Assembly: &quot;A&quot; company</td>
<td>Assembly: &quot;B&quot; company</td>
</tr>
<tr>
<td>Parts for engines, electrical systems, bodies, chassis, frame transmissions, and controls, etc.</td>
<td>Buy</td>
<td>Buy (buy ratio: 65%)</td>
</tr>
<tr>
<td>Secondary and tertiary subcontracts</td>
<td></td>
<td></td>
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<tr>
<td>Presses, plate, and coil welding, drawings, scaffolding, castings, and forgings, plastic parts, rubber parts, etc.</td>
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<th>Bodies for buses, trucks, passenger cars (420,000)</th>
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<tr>
<td>Internal combustion engines (225,000)</td>
</tr>
<tr>
<td>Agricultural, gardening machinery, and parts (364,000)</td>
</tr>
<tr>
<td>Material handling machinery (217,000)</td>
</tr>
<tr>
<td>Parts, accessories, etc. (654,000)</td>
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</table>


Note: "A" company represents Toyota while "B" company represents General Motors.

General Motors, with its in-house operations, employed "430,000 workers in the United States alone" in 1991, while Toyota employed only about 70,000 workers in Japan with approximately the same output in total vehicles (Shimizu
Furthermore, unlike the independent Japanese keiretsu suppliers of auto parts which act as if they were a part of the parent company or at least closely affiliated with the car maker, American auto parts suppliers are completely independent parts manufacturers, and do not affiliate (Matsui 1988, 49) with the car manufacturer except through contractual relations.

A second characteristic of the Japanese structure is that the manufacturing of automobile parts is concentrated in a relatively few parts suppliers because of the existence of production keiretsu (ibid, 49-50). Approximately 400 automobile parts suppliers, out of more than 10,000 in Japan, belong to production keiretsu of car manufactures, and they produce 90 percent of the total production (ibid). A typical Japanese automobile maker deals directly with only about 200 to 300 of their keiretsu affiliated parts manufacturers, while in the United States, General Motors, for example, maintains direct contact with about 3,500 parts makers for "just assembly work alone" (Mitsubishi Research Institute 1987, 4). There are over 15,000 independent suppliers in the United States.

A third characteristic is that the automobile part suppliers are generally less diversified than their American counterparts. The larger part supplier in Japan become, the less likely it is to diversify. A 1981 study shows that, on average, 92 percent of the first-tier automobile parts
companies produced only auto parts (Oshima and McCraeken 1984, 88-89). Similarly, smaller Japanese auto parts makers tend to specialize, and 82 percent of their total sales come from these automobile parts (ibid). In the United States, on the other hand, only six parts supplying companies of the top 78 suppliers earned over 35 percent from sales of auto parts in 1981 (ibid, 80). Many of these American firms were diversified into small motors and other types of equipment. One-third of the 78 United States companies reported that only 5 percent of their total sales came from sales of car parts (ibid).

A fourth characteristic of the Japanese automobile production structure is that it is typically based on the system of subcontracting with firms within the car manufacturer’s vertical keiretsu. Unlike the Western version of the word subcontracting, the word for subcontracting (shitauke) in Japanese implies more hierarchical and paternalistic ties between a manufacturer and subcontractors (Asanuma 1985, 33; Shoda 1987, 10). It is not based solely on contractual relations as in the United States.

Although Japanese subcontractors are legally independent firms, the tie between a parent firm and subcontractors implies a subordinate relationship. Japanese subcontractors are considered to belong to a parent company first, rather than to the industry “in much the same way that Japanese
employees in a company belong to the company first, and to a profession second" (Sheard 1983, 52). In the United States, on the other hand, this is entirely different. Subcontracting implies more or less equal partnership between a manufacturer and a subcontractor. Subcontractors maintain their autonomy and are bound only by the contractual requirements.

The Japanese system of production keiretsu in the automobile industry is semi-vertically integrated since an automobile maker and auto-parts suppliers enjoy legal autonomy and independence. In reality, they are connected to each other by the system of "multistage specialization" as shown in Table 5 (Shimokawa 1985, 6). This figure shows that there are at least three tiers of suppliers in production keiretsu of automobile manufacturers.

The automobile maker is at the top of the hierarchical structure, and many automobile parts makers are arranged as subcontractors in layers beneath them. The manufacturer subcontracts with the parts suppliers in the first tier for the key functional auto parts. The second tier represents firms with subcontracts with the first tier and the third tier, which is still another group of firms producing under a subcontract with the second tier firm.
Table 5. Multiple Layers of Subcontractors and Their Tie with an Automobile Manufacturer

A car manufacturer

1. First tier parts suppliers
2. Second tier parts makers
3. Third tier parts suppliers

Source: compiled from McCrow and O'Brien 1986, 81; Matsui 1988, 12.

Many of the Japanese first-tier automobile parts companies are equivalent in terms of operation, scale, and production capability to in-house divisions of American automobile assemblers. They engage in production of key functional auto-parts, such as engines, brakes, clutches, body panels, and seats, which require special design, specification, and delivery date. They have direct contact with the automobile maker and have the capability to develop their own designs and technology. They often do joint research and development projects with an automobile assembler. At the same time, they also act as a parent company for a lower layer auto parts firm since they "farm out the production of a number of components or stages in the production process" (Sheard 1983, 56).

The second and third-tier automobile parts suppliers, on the other hand, work as subcontractors to the first and
second-tier auto parts companies. They usually engage in the production of less sophisticated standardized parts such as springs and plugs and in manufacturing such items as cogs, nuts, bolts, and screws, and "engineering services and dies" such as body parts and small dies (ibid, 55). At the third level the firms are part of the production processing in plating, casting, welding, forging, and pressing, as well as production of single items of standardized auto parts such as screws and washers (Czinkota and Woronoff 1986, 43).

The number of first-tier subcontracting firms for an automobile maker is between 200 to 300 (Mitsubishi Research Institute 1987, 3). There are several thousand second-layer auto-parts makers and over ten thousand third-layer auto-parts makers working indirectly for an auto maker as subcontractors (Sheard 1983). Although independent, these firms are largely controlled by the car manufacturer through the influence of the keiretsu.

Non-keiretsu firms mainly produce automobile parts that require "no special specifications" from automobile makers such as plugs, sheet metal, and shock absorbers. They are sold to "multiple customers" or automobile makers (Uekusa 1987, 500). Parts that are standardized and supplied in large quantities, such as tires, bearings, and batteries, also may be made by large-scale non-keiretsu suppliers, and sometimes these firms are within a horizontal keiretsu producing rubber, steel, glass, electronics products, and
other products.

A fifth characteristic of production keiretsu in the automobile industry is that there is a large gap in size and production capability between the first-tier and other-tiers of auto parts manufacturers. The first tier suppliers are large companies with over 300 employees and a total annual sales ranging up to hundreds of billions of yen (Oshima and McCraeken 1984, 88). The second tier firms in these production keiretsu are mostly small and medium sized companies with between 30 and 299 employees and a capital investment of less than one hundred million yen. Their total sale's volume amounts to less than five billion yen per year (ibid). The third-tier companies often are small firms with less than 30 employees (Sheard 1983, 55).

A sixth characteristic is that Japanese automobile companies organize part suppliers into cooperative associations called "kyoryoku kai" to encourage interaction between the automobile makers and the first line parts makers (Mitsubishi Research Institute 1987, 3). One aim of these cooperative associations is to solidify business ties between an automobile maker and the auto parts suppliers. As a part of the keiretsu, these cooperative associations strengthened the ties between parties within the production keiretsu. Each association is made up of members of key suppliers of parts (ibid). These are the elite companies since they are selected by a parent automobile maker company
and they produce the key functional parts for the car maker. The associations engage in study meetings and exchange of information for production efficiency, quality improvement, and other production related activities such as research and development under the leadership of a parent automobile maker (Minato 1989, 6; Mitsubishi Research Institute 1987, 3). In addition, cooperative associations sponsor social activities designed to encourage a common vision and harmonious working relations among all parties. Toyota, for example, has a supplier organization of auto parts makers called kyoho kai and has branches of this throughout its geographic area. The firms within the kyoho kai (cooperative association) of Toyota are shown in Table 6.

All 11 of the automobile makers in Japan, except Honda, have organized their suppliers into a cooperative association. Honda has about 300 primary auto parts suppliers, but they are not organized into a cooperative association (Odaka, Ono, and Adachi 1988, 255) partly because it produces many of its vehicles in the United States and Canada and relies in part on independent and foreign parts makers. Members of the cooperative associations for suppliers of smaller Japanese automobile makers include auto parts suppliers who also are affiliated with either Toyota or Nissan, the largest car makers in the country. For example, 178 primary members of the yoko kai
cooperative association of Mazda Motor Company include affiliates of either Toyota or Nissan, while other suppliers are independent auto parts makers outside of any production keiretsu (Dodwell Marketing Consultants 1986, 57).

Table 6. Companies with Toyota's Kyoho Kai

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<tr>
<td>Tokai Kyoho kai</td>
<td>Yamaha Motor Co.</td>
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<tr>
<td>(Regional cooperative</td>
<td>Aichi Steel Work Ltd.</td>
<td></td>
</tr>
<tr>
<td>association)</td>
<td>Toyoda Machine Works,</td>
<td></td>
</tr>
<tr>
<td>members: 141 companies</td>
<td>Ltd.</td>
<td></td>
</tr>
<tr>
<td>established: December 1943</td>
<td>Futaba Industrial Co.</td>
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<td></td>
<td>Kyowa Leather Cloth Co.</td>
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<td>Takai Rubber Ind., Co.</td>
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<td>Toyota Auto Body Co.</td>
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<td>Toyota Gosei Co.</td>
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<td>Aisan Industry Co.</td>
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<td>Daido Metal Co.</td>
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<td>Nippondenso Co.</td>
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<td></td>
<td>NGK Spark Plug Co., and others</td>
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<tr>
<td>Kanto Kyoho kai</td>
<td>Akebono Brake Ind., Co.</td>
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<tr>
<td>(Regional cooperative</td>
<td>Ichiko Ind., Ltd.</td>
<td></td>
</tr>
<tr>
<td>members: 63 companies</td>
<td>Toshiba Corp., and others</td>
<td></td>
</tr>
<tr>
<td>established: July 1946</td>
<td></td>
<td></td>
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<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Kansai Kyoho kai</td>
<td>Kansai Paint Co.</td>
<td></td>
</tr>
<tr>
<td>(Regional cooperative</td>
<td>Sumitomo Electric Ind., Co.</td>
<td></td>
</tr>
<tr>
<td>association)</td>
<td>Yuasa Battery Co.</td>
<td></td>
</tr>
<tr>
<td>members: 26 companies</td>
<td>Yuminoe Textile, and others</td>
<td></td>
</tr>
<tr>
<td>established: January 1947</td>
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Development of Automobile Production Keiretsu

The origin of production keiretsu in Japan can be traced to the pre-World War II era. In the 1930s, the Japanese economy was mobilized to promote industrialization and militarization. The government, especially the military
government in the 1930s, encouraged the development of production keiretsu to increase national production.

Development of automobile production facilities and the parts industry was thought to be essential if there were to be a sufficient supply of military vehicles, especially trucks (Odaka, Ono, and Adachi 1988, 282-283). The government supported domestic automobile makers and auto component firms by encouraging close ties between them. For example, the government enacted the Act of Aid for the Production of Military Vehicles of 1918 which assisted potential automobile manufacturers, such as the Tokyo Gas and Electric Company, and Kawashima Company, the originator of Nissan, to build trucks. It aided companies by securing "basic materials" and providing "blue prints" of designs and "technical advice" (ibid, 26). Although the act of 1918 stimulated the production of trucks, the output of military vehicles was very small since the capability of manufacturers was limited.

Government assistance increased after numerous individual and family firms failed in their efforts to produce automobiles. Prior to 1916 there were no well established Japanese automobile manufacturers in the country although the automobile had been introduced into Japan in 1899. Those few firms or individuals who attempted to enter the field of automobile production usually committed themselves only to a trial basis or were inventors who
sought to utilize their own ideas (ibid, 266). Most of these firms were small family type businesses, and most failed within a short period (ibid). Automobile production was not within the usual capabilities of most family businesses since the relevant technology level and supporting works, such as machine tools and parts production, were not available in the country at that time.

Recognition of the difficulties facing family businesses in automobile manufacturing was one of the reasons why the large family industrial cliques (zaibatsu), such as Mitsui, Mitsubishi, and Sumitomo did not enter the field of automobile production despite the urging of the government. Only the Mitsubishi zaibatsu showed any interest in this area of production (Chang 1981, 18). The Mitsui and Sumitomo zaibatsu decided not to enter the field for two reasons: (1) they considered the production of automobiles to be very costly and risky since it required large capital outlays, and (2) essential machine tool and equipment companies were in their infancy (ibid, 18-19).

Furthermore, two large American car firms, General Motors and Ford already were operating assembly plants in Japan (ibid, 19). The competition from these well-established car companies was deemed too intense for local industry to overcome.

Production and marketing of automobiles in Japan before World War II were dominated by Western companies, especially
American companies. Ford and General Motors produced about 250,000 units of automobiles in Japan from 1923 through 1939, and they dominated about 90 percent of the Japanese market until 1934 (ibid, 16). The auto parts market also was dominated by American firms in this period.

The increase in political tensions between Japan and Western powers in the 1930s led to a change from the use of foreign equipment. Japanese manufacturers, including Tokyo Gas and Electric, Tokyo Motors, Nissan, and Toyota were called upon by the government to meet the domestic need for automobiles and auto parts. By 1940, Ford and General Motors were forced out of Japan (Odaka, Ono, and Adachi 1988, 279).

The new automobile manufacturers found themselves facing a serious situation as they sought to replace the established American plants since the Japanese companies making auto-parts were either nonexistent or in their infancy. The new car manufacturers were forced to provide financial and technical assistance to struggling auto-parts suppliers so that they could produce essential parts for their plants.

With the help of the government, the industry eventually created the first production keiretsu for manufacturing trucks in the mid 1930s. The Automobile Industry Act of 1936 called for full-fledged domestication of the automobile industry and provided a number of programs
to help the automobile industry. Although the Act did not directly specify that automobile manufacturers must use domestic parts, its objective to promote local auto parts manufacturers was clear. Domestic companies were to totally domesticate the manufacturing of trucks (ibid, 267), including the making of parts. It should be noted that there was no Japanese concept of anti-monopoly law to prevent the development of the necessary close relations between independent firms required in a keiretsu.

The government also helped the automobile industry to develop suppliers of parts to meet the demand of the military government. This pattern of hierarchical ties between an automobile maker and numerous auto-parts makers set an early precedent for the later production keiretsu. Thus, it can be seen that development of the automobile industry and the production keiretsu in the prewar era was primarily in response to governmental actions.

Postwar Development of the Automobile Production Keiretsu

Although foundations for the automobile production keiretsu built on a subcontracting production system were laid before World War II, significant expansion and modification of keiretsu occurred after World War II. In contrast to the prewar pattern, after the war, a major source of support for automobile parts suppliers came, not
from the government, but from automobile makers themselves and the major banks financially involved with them. The government's support of the automobile industry has continued to be mainly through indirect aid such as the creation of a favorable environment for the development of production keiretsu and lenient enforcement of the anti-monopoly law enacted in response to the wishes of the United States during the post war period.

Production keiretsu developed in the post war era for several reasons. First, the level of technology in machinery, such as plating, casting, smelting, and tooling was still low, forcing automobile makers either to develop the abilities of producing parts themselves or to support companies which could perform these functions for them (Shimokawa 1985, 10). Second, automobile makers did not possess the ability to internally produce the needed tens of thousands or so of different auto parts (ibid). Third, it was considered to be more advantageous for automobile makers to buy parts from part makers than to produce them internally (ibid), since they would avoid large capital outlays and expenses of training and maintaining a large work force. Moreover, major automobile makers such as Toyota and Nissan, which resumed production of automobiles in the post war period, faced major labor and financial problems in the late 1940s (Odaka, Ono, and Adachi 1988, 225). The financial problems faced by Toyota and Nissan led
to closer ties with major banks. For example, after the dissolution of zaibatsu by the occupation government, the Mitsui Bank became one of the largest shareholders for Toyota Motors. Similarly, Fuji Banks, Industrial Bank of Japan, and life insurance companies of the Fuyo group became major shareholders for Nissan Motor Company, since all these companies needed a large infusion of new capital.

The most dramatic growth of production keiretsu for Japanese automobile makers came during the period of the rapid growth in the national economy and the surge in demand for passenger cars in the 1960s. Automobile makers, at the same time, began to consolidate their production by selecting and fostering a limited number of primary suppliers of parts. They undertook this action to help them cope with the possibility of having foreign competitors invest in the country as a result of the government's policies of liberalizing capital investment and trade regulations.

Domestic automobile manufacturers established a system of purchasing each key automobile part from two different auto suppliers, which were encouraged to compete against each other within the keiretsu. For example, the founder of Toyota Motor Company, Kiichiro Toyoda, in his guidelines pertaining to parts suppliers, stated that the number of suppliers for each key auto part should be neither more nor less than two in order to solidify but maintain a
competition among suppliers (ibid, 68). Other suppliers, losing the competition for the two designated parts makers, were forced to reorganize and work under the two primary suppliers, as second or third tier suppliers in the keiretsu, or to set out on their own as independent firms.

Even within the Toyota Motor company, however, production keiretsu members were created or selected in several different patterns. Some member companies evolved into independent firms from departments of either Toyota Automatic Loom Works or Toyota Motor Company. Examples of such firms are Nippondenso and Aichi Seiko, which produce spark plugs and electronic components. Toyota Motor Company retained a portion of the stock of these companies and continues to send management staff to operate them (Okumura 1990, 94-95). Independent firms also have become keiretsu members as a result of the automobile manufacturer purchasing a major portion of the stocks of these firms. Examples of such companies in Toyota Motor Company’s keiretsu include Koito Manufacturing Company, Ichiko Kogyo, Kayoba Kogyo, and Nihon Piston Ring Company. Toyota Motor Company controls the top ranking managers or directors in these companies, since it is the largest shareholder (ibid).

Other Toyota production keiretsu members were brought into the company’s fold as result of Toyota’s assistance to financially troubled auto parts makers. An example of this pattern is Koyoseiko Company, an auto bearing company, which
was financially insolvent before Toyota purchased 17.6 percent of its shares and became its largest stockholder. As the largest stockholder, Toyota sent senior managers to direct the company (ibid, 96). Toyota's equity in member firms of its production keiretsu is shown in Table 7.

<table>
<thead>
<tr>
<th>Major Toyota Group Manufacturing Companies</th>
<th>Toyota's Equity (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aishin Seiki Co.</td>
<td>22.3</td>
</tr>
<tr>
<td>Aichi Auto Works, Ltd</td>
<td>21.3</td>
</tr>
<tr>
<td>Kanto Auto Works, Ltd</td>
<td>48.9</td>
</tr>
<tr>
<td>Toyota Auto Body Co.</td>
<td>41.7</td>
</tr>
<tr>
<td>Tokyo Toyota Motor Co.</td>
<td>61.9</td>
</tr>
<tr>
<td>Toyota Machine Works, Ltd</td>
<td>23.9</td>
</tr>
<tr>
<td>Toyota Gosei Co.</td>
<td>40.4</td>
</tr>
<tr>
<td>Toyota Automotive Loom Works Co.</td>
<td>24.8</td>
</tr>
<tr>
<td>Toyota Tsusho Co.</td>
<td>21.7</td>
</tr>
<tr>
<td>Nippondenso</td>
<td>22.9</td>
</tr>
<tr>
<td>Koyo Seiko Co.</td>
<td>17.6</td>
</tr>
<tr>
<td>Daihatsu Motor Co.</td>
<td>14.1</td>
</tr>
<tr>
<td>Hino Motor Co.</td>
<td>10.3</td>
</tr>
<tr>
<td>Koito Mtg Co.</td>
<td>19.0</td>
</tr>
<tr>
<td>Toyota Spinning and Wearing Co.</td>
<td>8.9</td>
</tr>
</tbody>
</table>

Note: Listed only firms on Japan's stock exchange market.

Source: Okumura 1990, 94.

The patterns of formation of the production keiretsu of Nissan Motor Company were somewhat different from Toyota's. The Nissan production keiretsu developed mainly through mergers or acquisition of shares of independent companies. For example, Prince Motor Company was absorbed by Nissan Motor Company in a merger in 1966, and Aichi Machinery Industry company was brought into its production keiretsu as
a result of Nissan providing it with financial and managerial assistance during a period of financial difficulty in 1962 (The Oriental Economist 1970, 18).

The transfer of Nissan Motor Company's managers to keiretsu member companies, unlike the Toyota production keiretsu group, has not been dominated by personal family members from the parent firm. The Nissan group, however, generally has closer ties with financial institutions for the group than other major auto-makers such as Toyota and Honda. The Industrial Bank of Japan not only serves as the chief bank of Nissan but also serves all firms in the keiretsu. Many of the principal management officers of Nissan Motor Company and other keiretsu member firms came from the Industrial Bank of Japan (ibid, 19). The percentage of equity held by Nissan in members of the Nissan production keiretsu are shown in Table 8. As can be seen, they hold a larger percentage of the stocks on average than Toyota in its group.
Table 8. Percentage of Nissan's Equity in Major Member Companies of Nissan's Production Keiretsu

<table>
<thead>
<tr>
<th>Major Nissan Group Manufacturing Companies</th>
<th>Nissan Equity (%)</th>
</tr>
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<tbody>
<tr>
<td>Aichi Machine Ind.</td>
<td>36.2</td>
</tr>
<tr>
<td>Atsugi Motor Parts</td>
<td>36.9</td>
</tr>
<tr>
<td>Fuji Kiko</td>
<td>29.8</td>
</tr>
<tr>
<td>Fuji Tekko</td>
<td>34.0</td>
</tr>
<tr>
<td>Hashimoto Forming Ind.</td>
<td>24.8</td>
</tr>
<tr>
<td>Ichiko Ind.</td>
<td>22.4</td>
</tr>
<tr>
<td>Jidosha Denki Kogyo</td>
<td>20.2</td>
</tr>
<tr>
<td>Kanto Seiki</td>
<td>40.2</td>
</tr>
<tr>
<td>Kasai Kogyo</td>
<td>24.5</td>
</tr>
<tr>
<td>Kinugawa Rubber Ind.</td>
<td>34.3</td>
</tr>
<tr>
<td>Kiriu Machine Mfg.</td>
<td>59.4</td>
</tr>
<tr>
<td>Nihon Radiator</td>
<td>35.4</td>
</tr>
<tr>
<td>Nippon Carburetor</td>
<td>24.7</td>
</tr>
<tr>
<td>Nissan Shatai</td>
<td>44.2</td>
</tr>
<tr>
<td>Shin Nippon Forging</td>
<td>34.8</td>
</tr>
<tr>
<td>Tochigi Fuji Sangyo</td>
<td>20.9</td>
</tr>
<tr>
<td>Tokyo Sokuhan</td>
<td>49.1</td>
</tr>
</tbody>
</table>

Note: Listed only firms on Japan's stock market exchanges.

Source: Dodwell Marketing Consultants 1986, 42-44.

The member firms of the Nissan keiretsu, with few exceptions, are smaller than those of Toyota. This is due, in part, to the fact that the production keiretsu of Nissan was founded only in the mid 1950s whereas the Toyota keiretsu started in the 1930s and was resurrected soon after World War II. Although Nissan Motor Company was founded four years earlier than Toyota in 1933, Nissan Motor Company did not reestablish a production keiretsu until the mid 1950s (The Oriental Economist 1970, 19). Toyota's production keiretsu with 10 core members was already in operation by the time Nissan began to reestablish its group...
Nissan has tried to overcome this late start by bringing more independent auto parts and manufacturers into its group through a vigorous program of buying the stocks of these companies.

Smaller automobile makers such as Honda, Mazda, Mitsubishi, and Isuzu Motor companies formed production keiretsu even later than both Toyota and Nissan. They are dependent in part for their supply of auto parts from parts makers affiliated with both Toyota and Nissan since the ability of their own affiliated auto parts suppliers is limited. As these automobile makers began to set up direct production facilities in North America in the 1980s, unlike the larger car makers, neither they, nor their keiretsu firms, were strong enough to establish auto parts plants. When Honda established its Ohio auto plants in 1982 as the first Japanese automobile maker in the United States, it jointly established auto parts supplier plants with several of its Japanese affiliated and independent auto suppliers (Dodwell Marketing Consultants 1986, 50). A number of the smaller Japanese automobile makers also have entered business arrangements with other small Japanese automobile makers for producing standardized parts for both of the firms. For example, Mazda and Mitsubishi Motor companies agreed to share "functional parts" such as brakes and clutches to minimize costs of production so as to cope with the increasing value of the yen against the dollar after
1986 (ibid, 57). Similarly, Mitsubishi Motor Company also agreed to "share truck parts with Hino, Isuzu, and Nissan Diesel" to overcome its inability to produce an adequate supply of parts (ibid, 65).

Impact of the Automobile Production Keiretsu on Domestic and International Economy

An attempt to weigh the benefits of production keiretsu for automobile manufacturers raises several issues. Observations of the production keiretsu solely from the perspective of its economic benefit to the parent firm overlooks possible drawbacks to the subcontracting parts makers in the keiretsu and other independent non-keiretsu firms. The impact of production keiretsu on competition in the economy generally also is neglected. This study seeks to evaluate both the positive and negative impacts of automobile production keiretsu on the internal and external economies of all firms within the group and on domestic and foreign competitors.

The effectiveness of Japanese firms in the production of industrial durable goods, such as automobile and electrical appliances, has been pointed out by numerous observers (Mitsubishi Research Institute 1987; Miwa 1990; Sheard 1983). Some, such as Florida and Kenney, are so impressed with the Japanese system of production that they propose that the system of keiretsu be introduced into the
manufacturing processes in the United States (Florida and Kenney 1991). The continuous and long term ties between the parent company and subcontractors are especially seen as having particular merit (Florida and Kenney 1991, 394; Mitsubishi Research Institute 1987; Sheard 1983). The automobile maker, at the same time, enjoys a continuous and stable business relationship as a result of the subcontracting system, and yet it can maintain competition among subcontractors by selecting plural suppliers for each unit of auto parts (Mitsubishi Research Institute 1987, 10).

Having regular business ties between the parent company and the primary auto parts suppliers also means that companies are more willing to adapt to changes faced by the parent company (Negishi 1990, 23).

The production keiretsu also is seen as a means for the large parent automobile maker to take advantage of the wage gap between the automobile maker and auto parts suppliers. Automobile makers also profit from the system of subcontracting for their parts since the subcontractors serve as a buffer against economic fluctuations (Asanuma 1985, 33). This type of favorable evaluation of production keiretsu considers its value only from the perspective of the parent firm and fails to consider either its impact on the subcontracting firms or the economy generally.

Other observers contend that production keiretsu also serve the interest of the entire economy since the system
promotes technological improvements, improvements in management, and lowering costs of production (Asanuma 1985, 37; Hoffman and Kaplinsky 1988, 159; Mitsubishi Research Institute 1987; Sheard 1983). The automobile makers' close ties with a few selected parts manufacturers through the production keiretsu is thought to facilitate cooperation of suppliers and results in the development of better quality products (Kelly et al. 1992; Mitsubishi Research Institute 1987, 10). Production keiretsu are believed to offer a smooth continuous exchange of information and innovative ideas (Miwa 1990, 64-65). This type of grouping also makes it possible to follow the more efficient just-in-time (JIT) production system as a result of physical closeness in the location of production and regular interactions and communications between the automobile maker and a selected number of key auto suppliers (Florida and Kenney 1991, 392-393; Sheard 1983).

Several advantages are claimed for the JIT production technique, which was first introduced by Toyota. It is claimed that this production technique causes a reduction in labor time to produce products, a reduction in defects and an improvement of quality, a reduction in needed plant size, and a greater involvement of line workers in the decision making process to ensure quality (Sayer 1986, 53; Waller 1985, 26). These improvements are said to result from having no redundant inventory of auto parts either at the
automobile makers plant or at auto parts makers facilities (Hoffman and Kaplinsky 1988, 132; Matsui 1988, 226). Management of inventory and orders of auto parts are made in the production keiretsu, and the fact that the workers on the production line are more responsible for quality results in greater efficiency. The quality of their output and their efficiency exceeds that of in-house operations of American automobile manufacturers and their independent auto parts suppliers (Noguchi 1990, 144-45).

Cooperation and technological innovation between automobile and auto parts makers are also facilitated by the loyalty of auto parts associations to one specific automobile maker. Suppliers associations are seen by auto parts suppliers as means of gaining technological, financial, managerial, and marketing assistance from their respective automobile maker. From the parent company's point of view, these associations are an effective tool to cultivate loyalty among member firms in the keiretsu (Odaka, Ono, and Adachi 1988, 255). For example, membership of Toyota's suppliers association, Kyoho Kai, is largely under the guidance of Toyota, even though in theory this association is a voluntary organization made up of independent suppliers of auto parts makers.

There are a number of negative aspects of automobile production keiretsu which must be considered. First, subcontractors in keiretsu find it difficult to diversify
products which might assist them to weather economic downturns since they must devote so much of their attention to the concerns of their major automobile maker (Hoffman and Kaplinsky 1988, 159). The well-being or fortune of subcontracting firms is so closely tied to their major automobile maker that they usually cannot produce parts for another automobile maker without the approval of the parent company. Furthermore, increases in production costs by the parent automobile maker may in part be passed on to the subcontractors. The automobile maker can pressure them to lower cost for parts simply by threatening them with less business since the subcontracting companies are dependent on the parent company for most of their sales. There is little that a subcontractor can do but absorb the loss in revenue because of the superior-inferior relationship between the parent firm and keiretsu members.

Subcontractors, as a result of their weak position, vis a vis the parent company, often become victims of a profit margin squeeze by their parent firm. This is especially true during times of economic adversity (Sato 1987, 118). For instance, in 1986 at the time of the yen evaluation from the level of 242 yen to 160 yen per American dollar, Japanese automobile makers made a policy of cost reduction against their keiretsu auto parts makers uniformly. They ordered a production cost reduction up to 3 to 4 percent (Matsui 1988, 27). Toyota asked its keiretsu suppliers to
cut production cost by 2 to 3 percent. Similarly, Nissan and other automobile makers ordered their keiretsu auto parts suppliers to cut from 4 to 5 percent (ibid). These reductions in costs were devastating to most auto parts suppliers since these requests exceeded their profit margin of 3 to 5 percent (ibid). They were forced to go along with this request because they were not as diversified as the non-keiretsu firms. Cost reduction also creates fewer orders for the lesser tier processing works or manufacturer in the keiretsu since most first-tier subcontracting firms during these periods of less demand rely more on their own in-house production as a means of cutting cost (ibid, 29). First tier parts makers may avoid having to lay off employees by these means, but second and third tier companies suffer greater economic loss and may have to close plants or lay off workers.

The just-in-time production technique, which is often praised by the parent companies, also has a negative side for subcontracting firms. Less inventory of auto parts at a parent manufacturer may require the subcontracting auto parts suppliers to store a larger inventory to meet requirements in case the production facilities for some reason cannot meet the time requirements of the parent firm. Parts suppliers also often are obliged to invest capital in different types of machinery, so that they can produce the many different types of parts which they are called upon to
supply with little advance notice. Furthermore, the frequent and continuous transportation of auto-parts from parts makers to the parent company increases their transportation costs as well as aggravating traffic congestion and air pollution in Japan.

More significant to the domestic and external economy is the fact that production keiretsu exclude non-keiretsu firms from getting orders for auto parts. In this fashion, it decreases competition outside the keiretsu, while at the same time forces severe competition within the keiretsu. Both Japanese and foreign auto parts firms not in a keiretsu find it difficult to sell their products directly to Japanese automobile makers such as Toyota and Nissan. The ties between the parent companies and the first tier firms in the keiretsu are so close that automobile makers cannot make outside contracts for parts without some kind of special arrangement with their own keiretsu members. Trust and reliance between members of the keiretsu, especially the first-tier firms, has been built through years as a result of working together, making common investments and sharing management personnel. These close ties blur the boundaries between these companies. It is almost impossible, therefore, for an automobile maker to make decisions solely on a cost basis which might favor a non-keiretsu Japanese or foreign firm.

Managers of Japanese automobile makers often suggest
that if conditions, such as quality and price, are the same for keiretsu and non-keiretsu firms, they will buy them from keiretsu auto suppliers. But if auto parts products of non-keiretsu companies are superior or lower in price, they will buy from the non-keiretsu firms. In practice, however, Japanese automobile makers tend to keep business ties within the keiretsu even when their prices are higher, rather than replacing them with new competitive independent auto parts companies. They may require the keiretsu auto parts suppliers to meet the price and quality of non-keiretsu auto parts makers, but they seldom select an independent parts maker over their own keiretsu firms (Okumura 1990).

An illustration of the difficulty of conducting business with a Japanese keiretsu automobile maker is shown in the following experience of an executive of an American auto parts supplier:

I went to Japan, visited Nissan headquarters and asked to see their parts specification so I could propose a bid. Their response was straightforward but hardly what I had expected: "We do not have a specification. In fact, we know very little about that part. What we do have is two suppliers in Nissan group who have met all our needs for that type of component for many years. If you want to sell to Nissan, you will have to make same sort of arrangement with these suppliers" (Womack 1987, 23).

Recently, Japanese automobile makers in both the American and Japanese market have been politically compelled to buy more American auto parts. Japanese automobile makers have begun to contract with American auto parts makers in an
attempt to respond to the American government's demands for lessening the bilateral trade imbalance between Japan and the United States. This response was made for two reasons: (1) an attempt to satisfy the American automobile industry's demand that Japan purchase more of its auto parts in the United States and (2) to open its market in Japan for these parts. Despite the recent increases of American parts in Japanese cars, American auto parts manufacturers continue to complain that Japan maintains largely a closed market for auto part products because of keiretsu and the trade practices they create. Japanese automobile makers, on the other hand, claim that American parts are inferior and higher priced. As a solution, they often propose joint ventures with their American counterparts so that they can better control quality and price. Standard auto parts and related items, such as tires and brakes, may be purchased from non-keiretsu Japanese and foreign auto parts dealers, but seldom do Japanese automobile makers go outside their keiretsu for key components such as engines, transmissions, etc. American and non-keiretsu Japanese firms are largely closed out of these markets. A major portion of purchases by Japanese automobile makers of the key auto parts, even by Honda, has been from their Japanese keiretsu auto parts firms, despite the political pressures in America.

Although mergers and acquisitions are not alien to Japanese companies in general, acquisitions of a member firm
of a keiretsu by a foreign or non-keiretsu domestic firm is almost impossible (Hasegawa 1991, 59) because of the nature of the production keiretsu. Whereas a financially troubled or weak company is normally subject to the threat of an outside takeover, such a firm in a Japanese production keiretsu is usually merged with another firm within the group through the help of the keiretsu's bank. The merger of Prince Motor Company into Nissan Motor Company in the early 1960s is an example. The member bank of the Nissan keiretsu, the Industrial Bank of Japan, arranged, with approval of the Japanese government, to merge the new company into Nissan when it got into financial trouble.

Although capital investment in Japanese automobile firms and auto parts companies is possible through the purchase of stock, a takeover of a keiretsu firm by a non-keiretsu firm has never occurred. American automobile companies, for example, have purchased stocks of Japanese automobile companies but have not been able to direct the management of these companies. For example, Ford Motor Company has owned up to 24 percent of Mazda, Chrysler has held 11 percent of Mitsubishi, and General Motors has owned 38 percent of Isuzu (The Dallas Morning News February 29, 1992, 10d). Gaining control of these companies by obtaining a majority of the shares, however, is very difficult, if not impossible, because "only 30 percent of outstanding shares are floated on the stock market" and the rest of the shares
are owned by the keiretsu companies (Hasegawa 1991, 59).

None of the American companies has ever been able to become the controlling power in a Japanese keiretsu firm in the automobile industry.

There were two major reasons historically that major Japanese automobile makers, such as Toyota and Nissan Motor companies, have owned stock shares of key makers of auto parts, sometimes even of auto part companies belonging to rival automobile makers. In the early 1960s, foreign pressures on Japan led the government to liberalize capital investments in the country and to open it to the international market. Japanese firms, fearing foreign takeovers, took defensive steps by offering their stocks to other domestic companies (Okumura 1990, 96). At the same time, they obtained a larger percentage of stocks of the independent auto parts and component companies to prevent takeovers of these firms by foreign capital (ibid).

This strategy to prevent foreign takeovers may be seen in actions pertaining to Koito Manufacturing company. Koito, one of the largest makers of automobile lamps and lighting equipment, was owned in the 1950s largely by Matsushita Electric Company and belonged to its production keiretsu (ibid, 95). Toyota in the 1960s obtained a large portion of the stocks of Koito company to ensure that no foreign takeover would occur, and since then it has greatly influenced its management (ibid). In 1991 an American
investor, T. Boone Pickens, attempted to take control of the management of Koito manufacturing company by acquiring stock in the company. Koito Manufacturing, as a component of the Toyota keiretsu, refused to accept the new management staff designated by Mr. Pickens. Despite his protests that the rules of the game were being changed, this refusal to accede to his wishes occurred even though Pickens was among the largest stockholders and held approximately 30% of the company's stocks. The company supported by Toyota, a minority share holder with 20% of its stocks, refused on the grounds that his efforts were a hostile takeover attempt. Eventually, Pickens sold his shares and reluctantly acknowledged his defeat. Similar problems of acquiring managerial control of firms within a keiretsu by outsiders is ubiquitous throughout the industry, although foreign capital investments may be made in the industry.

Another reason why automobile makers own stock in part companies of rival keiretsu is to prevent them from becoming exclusive producers for a rival company (ibid, 96). Ownership of stocks in these companies ensures a supply of parts when they are needed. The Ichiko Kogyo Company, a large auto lamp and lighting equipment producer, for example, belonged to Nissan Keiretsu group, but Toyota became the second largest shareholder in 1970 since it did not want this promising parts maker to be entirely controlled by a rival company (ibid, 95). Similarly, Nissan
Motor Company became the second largest shareholder of Nippon Piston Ring Company next to Toyota in this period (ibid, 95-96) for the same reason.

Recent Changes in Automobile Production Keiretsu

The production keiretsu in the automobile industry are not static even through they are created in part to ensure stability. Both the domestic and international political economy affect the automobile industry, and in turn the keiretsu firms. Recently, production keiretsu in the automobile industry have been forced by international political pressures to change and reshuffle their keiretsu members, especially those firms in the second or third tiers. Also the economic downturn in the domestic and world economies has affected production keiretsu members. The second and third tier auto parts suppliers are more vulnerable to economic downturn and may be cut off from keiretsu support as business declines. Japanese car makers and their first tier keiretsu firms had been forced by poor sales to look after themselves and to reduce the business support given to auto part firms in the keiretsu. A number of the keiretsu auto parts firms as a result have recently been forced to go out of business.

The pressure for change in production keiretsu can be traced to the period after the two oil embargoes in the 1970s when Japanese cars became very popular in America. A
flood of Japanese automobiles entered the American market, raising concern about the competitiveness of American automobile makers and the growing unemployment of American workers in the industry. America demanded that Japan reduce its exports of small cars to the United States in order that its car makers could have time to readapt from large to small cars. Although Japanese car makers resisted strenuously such limitations, the government of Japan stepped in and persuaded the industry to follow a political solution worked out in 1981. The solution called for a ceiling on the number of Japanese cars which could be exported to the United States for a period of three years. This ceiling, however, has continued to limit Japanese exports into the United States after it formally expired because of the continuing pressure of the American industry and government.

While the American national government demanded voluntary export limitations on Japanese cars to the United States, American state and local governments and automobile workers' unions began to invite Japanese automobile makers to invest in their communities in the United States. The states and their local governments offered numerous incentives to these Japanese companies to locate in their communities. Inducements included tax exemptions, prime real estate at low prices, and free utility extensions to their plants. Under these circumstance, Japanese automobile

These pioneer automobile makers in the American market before 1985 brought with them all of their ties to their selected auto parts suppliers in the keiretsu. The auto parts keiretsu firms independently or jointly with the automobile makers also set up manufacturing plants in the United States to produce non-strategic auto parts such as silencers, exhaust pipes, brake pipes, head lamps, car heaters, radiators, and air conditioners (Matsui 1988, 98). Auto parts requiring large capital investments such as wheels, bumpers, roofs, and other plastic parts were also manufactured in keiretsu firms in the United States. Key or
strategic auto parts, such as engines and transmissions, however, still were imported from Japan. These transplanted firms instituted Japanese business practices in their new locations in the United States, and although they used American workers and managers in these plants, they trained them in Japanese management practices. Only those auto part products that were standardized and lot items such as glass, steel, tires, plastic goods, seat belts, and carpets were locally procured in the American market (ibid, 99).

The direct investment of automobile parts makers in the United States caused a number of problems for Japanese auto parts producers. Those key auto parts companies in the keiretsu which accompanied their car makers to the United States now had to compete in the American market, and the lesser tiered auto parts makers who remained in Japan suffered a loss of business to the new American production facilities. As a result of having production facilities in the United States, coupled with the increasing political pressure to use more American products, Japanese automobile makers became more selective in ordering parts. They no longer limited their purchases solely to keiretsu affiliated suppliers. Some keiretsu auto parts suppliers in Japan and the United States, therefore, faced a survival threat due to an increase in competition and in less assurance of securing purchase orders from their parent companies.

Change in the value of international currency in the
last half of the 1980s also seriously affected many of the Japanese keiretsu firms. The increase in the value of the yen in comparison to the American dollar from 242 in 1985 to 160 in 1986 reflected the international competitiveness of Japanese industry, the growing imbalance of American trade, and the increasing demands by the American government for reevaluation of the currencies of five major industrial countries, including Japan. This change in the value of currency seriously impacted members of production keiretsu. In response to the increasing prices caused by this appreciation of the yen, all of the Japanese automobile makers insisted on a uniform cost reduction policy on auto parts. This action by automobile makers forced auto part firms to lower their prices and to absorb the increased costs caused by evaluation of the yen. Those auto parts suppliers who could not adjust to the cost reduction, mostly the lesser-tier auto suppliers, lost the contracts from their automobile makers and some were forced to go out of business.

Ironically, the appreciation of the yen did not increase imports of American industrial goods, including automobiles, into Japan, as might be expected under the logic of economic theory. In reality, the results were just the reverse. Instead of raising the price of Japanese goods and increasing foreign imports, it brought about increased productivity of Japanese manufacturers. The appreciation of
the yen, which increased cost of auto parts for the parent manufacturers, led them to demand lower prices from their keiretsu affiliates. Automobile makers simply did not accept a price rise of auto parts due to higher production costs triggered by the appreciation of the yen (Uekusa 1987, 502). They expected the keiretsu auto part firms to cut costs and compensate for the rise in production cost. This harsh demand forced auto parts businesses to further rationalize their production processes and to increase productivity so they could produce parts cheaper (ibid).

Accepted theories of international trade as a result of these actions did not work as expected.

American industrialists and others who had expected prices of Japanese cars to increase as a result of the appreciation of the yen now were faced with an even more productive Japanese automobile industry. Their prices remained low or even decreased, and demand for Japanese cars in the United States continued to be strong. As the Japanese share of the American market exceeded 30 percent in 1991, the share of the auto parts market by Japanese auto parts makers in keiretsu also increased. One consequence of this was that the American trade imbalance continued to grow, causing protest by the automobile industry and the American government. The American automobile industry focused its protests on the practices of keiretsu firms supplying auto parts. It demanded that the Japanese
automobile makers purchase more auto parts from American part makers.

The continuing appreciation of the yen, along with the "voluntary" retention of the quota on cars entering America from Japan, caused other automobile makers, such as Mazda, Mitsubishi, Isuzu, Fuji, and Suzuki, to open plants in the United States. They believed that they would be closed out of the North American market entirely unless they moved to America. Many of these companies looked at the successful operations of Japanese predecessors, such as Honda, Toyota, and Nissan, and decided to open their own plants. Many of the smaller Japanese automobile makers, however, came to North America through joint ventures either with other Japanese or American automobile makers. For example, Fuji Heavy Industry and Isuzu Motors jointly established automobile plants in Indiana. Suzuki and General Motors jointly opened an automobile plant in Ontario. Mitsubishi and Chrysler began joint operations of automobile plants in Illinois.

Keiretsu firms supplying auto parts for these newly established automobile plants and some non-keiretsu auto parts suppliers from Japan accompanied them in their move to North America. These auto parts firms entered the North American market with an assumption that they could supply their products to both Japanese car makers and the big three automobile makers in the North America (Matsui 1988, 90).
The competition in the automobile market in the United States as a result of additional suppliers of new car and part makers increased greatly during this period, aggravating the anti-Japanese feelings of American industry and government.

Increasing pressure from the American automobile industry led the government to demand a political solution which would dictate that Japanese automobile makers purchase a larger share of auto parts from American owned firms. In bilateral trade negotiations between the two countries in 1987, Japanese automobile makers were obliged to report the amount of purchases of auto parts from locally owned American auto suppliers every six months for the next five years. According to this Market Oriented Sector Selective Agreement (MOSS), Japanese automobile makers were virtually forced to increase purchases of local auto parts in the United States, although the MOSS agreement did not specify a targeted rate (ibid, 225). The trade imbalance between the United States and Japan persisted as competition in the American automobile industry increased despite the MOSS agreement.

Political pressure in the United States by 1992 led the government to demand an action plan from the Japanese which would specify a percentage of American parts to be used in all cars sold in the American market. Under this plan, both Japanese owned plants in the United States, as well as
imports from Japan were to contain a specified percentage of American made parts. The purpose was to require Japanese automobile makers to purchase and import more auto parts from America. Table 9 shows that Japan increased imports of American auto parts from 1983 to 1990 and is expected to increase them even more by 1994.

Table 9. Purchases of American Auto Parts by Japanese Automobile Makers in Million Dollars:
1983 to 1990 and Estimates to 1994

<table>
<thead>
<tr>
<th></th>
<th>1983</th>
<th>1986</th>
<th>1990</th>
<th>1994 (Expected figure by the action plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japanese Imports</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local Purchases to the United States</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>923</td>
<td>1,946</td>
<td>9,000</td>
<td>190,000</td>
</tr>
</tbody>
</table>

Note: the figure of 1994 is made based on an estimation that Japanese automobile production would increase about 50 percent by 1994.


At the insistence of President Bush and a party of American automobile executives, who accompanied him to Tokyo in January 1992, the Japanese government and automobile makers agreed that they would make an effort to increase the purchase of locally made auto parts for cars manufactured in the United States from the level of 50 percent per car in
1990 to about 70 percent in 1994. Japanese exports of auto parts to be assembled in the United States are also expected to be reduced from the level of 50 percent in 1990 to about 30 percent of the total cost of an automobile in 1994. Although the Japanese agreed to increase imports of American auto parts, there was no firm agreement as to the percentage of American parts to be placed on cars made in Japan.

A major controversy in these recent bilateral talks was whether cars produced in North America by Japanese-owned plants are North American cars. Determining the nationality of cars became a major point of contention. The Japanese argued that American executives as well as workers who work for Japanese car makers, such as Honda, are making an American car. They point out that over 50% of the parts in these cars are locally made. At present, such cars, the Japanese argue, are eligible to cross the United States and Canadian border duty free according to the 1989 United States and Canadian trade agreement since they use over 50% of local products in the manufacture of these cars. There remains, however, a disagreement as to how the local contents of these automobiles are to be calculated (Shukan Daiyamondo 1990, 49). Honda, for instance, claims that their cars produced in the North America use a "domestic content" of 75% (Magnusson, Treece, and Symonds 1991, 105). American government officials, on the other hand, argue that Honda and other Japanese automobile makers in the United
States overestimate the local content. The argument centers around the American charge that many of the parts claimed to be locally made are in fact mostly a collection of "Japanese parts handled by Americans but designed, engineered, and fabricated in Japan" (ibid). Without the count of these types of parts, Americans argue that the content is actually much less than 50 percent of local parts. In fact, the office for the study of automobile transportation at the University of Michigan computed the percentage of parts in a Honda Civic in 1989 to be only 16%. If overhead and depreciation cost of Japanese capital equipment were included, the figure would still be only 36%. The argument has moved from determining the nationality of cars to determining the nationality of parts. Key Japanese automobile makers in the United States such as Honda, Toyota, and Nissan in the late 1980s made an effort to raise the ratio of local purchases of auto parts from 50 to 70 or 80% to ease bilateral trade tensions and clear the American 50% locally made parts criteria for customs. To accomplish this, they proposed either to enhance their own in-house ability to produce needed parts or to begin purchasing engines and transmissions from non-keiretsu firms in the United States since these products comprise about 30% of the total costs of automobile production.

This decision of Japanese automobile assemblers to increase purchases of local auto parts and to import less
from Japan had a serious impact on keiretsu auto parts suppliers in Japan. Local purchase of strategic parts such as engines and transmissions caused a reduction in the business of key keiretsu firms and even threatened a reduction of some members in the first-tier keiretsu of major Japanese automobile makers. Table 10 shows the change which has occurred in keiretsu operated parts firms of Toyota and Nissan motors.

<table>
<thead>
<tr>
<th></th>
<th>1979</th>
<th>1985</th>
<th>1991</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Toyota Motors</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kyoho Kai</td>
<td>225</td>
<td>176</td>
<td>176</td>
</tr>
<tr>
<td><strong>Nissan Motor Co.</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Takara Kai</td>
<td>112</td>
<td>105</td>
<td>104</td>
</tr>
</tbody>
</table>

Note: The Table shows the number of keiretsu firms supplying parts to Toyota and Nissan. Toyota and Nissan have other auto parts supplier organizations such as eiho kai for Toyota and shoho kai for Nissan, but they are not mainstream organizations for auto parts manufacturers. The eiho kai is, for example, members of contractors of facilities, plants and manufacturers of gauges, mold, etc. Honda is not shown because it does not officially have suppliers' organization although it has keiretsu suppliers. Many members of supplier organizations of smaller Japanese automakers include either Toyota or Nissan affiliated auto parts suppliers and they are duplicated in their membership. Thus, the analysis is restricted to Toyota and Nissan's supplier organizations.


A reduction of even one first tier firm in the family of keiretsu is an extremely serious occurrence in Japan since they have several thousands of second and third tier
firms dependent on them. All of these firms are subjected to being forced out of business unless the parent company assists them to diversify their business, which tends to be contrary to the ethos of a keiretsu. Furthermore, breaking strong social and economic bonds between a parent firm and a first tier keiretsu firm threatens the fundamental basis of Japanese business and society. How keiretsu, facing such economic and political problems, react and interact with government will be discussed in chapter V.

Conclusion

Bilateral trade between the United States and Japan is significantly affected by the industrial structural features of Japan, the system of keiretsu. These industrial groups in the case of automobiles create hierarchical ties between the automobile makers and their parts suppliers. This arrangement involves both social and economic ties with benefits and costs to both parties. The close production ties between an automobile maker and selected auto suppliers through technological, financial, and managerial connection, as well as the subcontracting system within the production keiretsu, improves productivity and permits competition among keiretsu suppliers and between keiretsu of different firms. One of the potential costs of production keiretsu is the possibility of abuse of power due to the superior position of the automobile makers over the auto parts
suppliers. Since the production keiretsu is essentially a hierarchical arrangement, the subordinate keiretsu firms are not equal partners. In difficult economic times, the keiretsu firms, especially lower tier firms, may suffer since they are dependent on the parent firm and are not diversified enough to stand on their own. The fact is that the production keiretsu system tends to exclude both foreign and Japanese non-keiretsu automobile makers and auto parts suppliers from trading with them. Penetration and participation by newcomers in existing production keiretsu is very difficult, especially among the production keiretsu of the major Japanese automobile makers. Western investors especially have been perplexed by the differences in the Japanese business practices and the difficulty of penetrating these keiretsu firms.

Despite the inherent resistance to change by production keiretsu, the automobile production keiretsu has been forced to change since the early 1980s and is faced with more serious environmental threats as the world economy changes. Pressures to modify the production keiretsu have increased as their business activities have moved abroad in response to the internationalization of these businesses. Pressures by foreign governments have continued to grow and threaten to force even greater changes in the business practices of keiretsu.
CHAPTER IV

AUTOMOBILE DISTRIBUTION KEIRETSU IN JAPAN

Distribution of Japanese automobiles involves still another type of industrial grouping. This chapter examines the nature of distribution keiretsu, their organizational structure, and their impact on the domestic and international economy. Finally, recent changes in automobile distribution keiretsu and the causes of these changes are explored.

The distribution system in Japan is characterized by multiple levels of distribution outlets composed of manufacturers' designated wholesalers for various levels or territories and numerous small retail outlets since there are few large independent retailers. The distribution keiretsu tie together the various levels of the distribution system from manufacturers to wholesalers to retailers (Shimaguchi and Lazer 1979, 51).

There are two contrasting views of the Japanese distribution keiretsu according to Yokogawa (1990). The view held by many economists, is that the Japanese distribution keiretsu provide an effective system for distributing goods and serves the interest of both business groups and consumers. According to this positive view, the distribution keiretsu provides a stable supply of
manufactured goods from manufacturers to users at a reasonable cost through their own channels of distribution (Shimokawa 1985, 17). Members of the keiretsu, according to this positive view, also are more responsive to consumers' demands for quality and service through their own sales channels than are independent non-keiretsu firms. Furthermore, manufacturers can create and maintain efficient routes of information and market activities through distribution keiretsu which benefits the economy generally (ibid).

Other economists and more recently, the Japanese regulatory agency, the Fair Trade Commission, hold a more skeptical view of distribution keiretsu. This more negative view contends that distribution keiretsu place control over distribution solely in the hands of manufacturers who manipulate policies to their advantage. Distribution keiretsu are seen by these critics as hierarchical business ties between a manufacturer and its distribution outlets, wholesalers, and retailers to control prices and to dominate the market (Ross 1983, 12).

This case study of the production and distribution of Japanese automobiles considers both of these evaluations of distribution keiretsu and attempts to evaluate the impact they have on the firms within the keiretsu, the general market and consumers. A number of factors, such as the size of the manufacturer, the nature of keiretsu and their
ability to dominate the market affect the degree of competition and the impact of the keiretsu on the domestic and international market. Later in this chapter an evaluation is made of the impact of Japanese distribution keiretsu in the automobile industry.

A Case Study of the Japanese Automobile Distribution System

The system of distribution of Japanese automobiles, like the system of production, is dominated by a keiretsu network of independent firms bound together by economic and social ties to their parent manufacturer. Table 11 shows the distribution system for new Japanese and foreign cars. All Japanese made new cars and most foreign made cars are sold in Japan through keiretsu dealers although independent dealers may be involved in the distribution of foreign made cars. Independent dealers in Japan tend to be very small and financially weak.

Each Japanese automobile maker has formed distribution channels by giving exclusive sales dealerships of various models of its cars for specified distribution areas. These exclusive franchise and territorial arrangements were copied from American automobile makers but modified to fit the Japanese culture. Japanese automobile makers have many more single model dealerships than American companies, and the relationships between the manufacturer and the dealers are much closer. Restrictions are usually placed on franchised
dealers, preventing them from handling car models other than those authorized in the franchise and from selling cars of their competitors. Normally, Japanese dealers of new cars cannot sell any except those models authorized by their manufacturer. Strict division of distribution channels of cars according to models, however, has become more difficult for Toyota, Nissan, and Mazda motors since each already has five separate sales channels for various models of their cars. When new models are introduced, the company increasingly is forced to market them through these channels and to create plural outlets for these new models.

Table 11. Distribution System for New Domestic and Foreign Cars in Japan

Japanese automobile dealers are much more dependent on their automobile makers than their western counterparts. The size of dealerships is smaller, and the financial standing of these firms much weaker. Almost a fourth of the dealerships are owned in part by the car makers, and the car makers own more than a 50 percent interest in the dealerships of 17 percent of these keiretsu firms. Loans from the manufacturers also provide much of the required capital of dealerships, and the share of capital actually owned by dealers accounts for only 6.1 percent of their total assets (Negishi 1990, 44). Automobile manufacturers also have attempted to strengthen dealerships by contributing managerial assistance. Often the dealership is operated by managers who are retirees from the automobile manufacturer. These conditions create a tradition whereby the car manufacturers rather than the dealerships determined when and how many cars each dealership is to receive. Only recently has this practice of the manufacturer forcing dealerships to accept the number of cars it decides to send been challenged by the Fair Trade Commission.

The pattern of selling automobiles in Japan is much more labor intensive since the dealerships send salesmen out into the community rather than waiting for customers to show up at the dealer’s lot. The volume of cars sold in Japan corresponds to the number of salesmen in dealerships (Pascale and Rohlen, 1983, 224). While in the United States
car salesmen sell about 8 to 10 cars per month on the average by working in a dealer's showroom, in Japan, salesmen sell 4 or 5 cars per month by soliciting sales door to door, but they send out many more salesmen (ibid, 223). Although a pattern of showroom sales at dealer shops has increased recently, door-to-door sales still predominates as the major style of salesmanship in Japan.

Formation of the Automobile Distribution Keiretsu

Japanese automobile makers adapted the sales franchise system used by General Motors and Ford in the Japanese market prior to World War II. Toyota Motor, the first Japanese automobile maker in 1936 replaced General Motors dealership with its own, originally to sell trucks (Uzawa and Komatsu 1991, 175). In time, it expanded the system of dealerships throughout Japan by contracting with local companies in other businesses (ibid). The pattern of Toyota's franchise system was followed by other Japanese automobile makers (ibid). Basically, Japanese automobile makers had to create an entire distribution system since the existing distribution system was not fully developed (Negishi 1990, 42).

The exclusive franchise system of automobile dealerships expanded rapidly in the 1960s as the market for domestic automobiles increased. Domestic demands for Japanese automobiles before the 1960s were very limited.
With the takeoff of the economy by the 1960s, Japanese automobile makers had to respond to the increased demand for automobiles by extending their distribution systems. The networks of exclusive dealers throughout Japan expanded rapidly. In many instances the automobile manufacturers financially assisted the newly created dealerships and often provided managerial assistance to their dealers. The pattern of close ties between Japanese automobile makers and their keiretsu dealers through financial and managerial assistance has changed little over the year although the recent financial downturn in the automobile industry had led automobile makers to attempt to make their dealership less dependent on them. This has caused a consolidation movement, and many dealerships have been forced out of business.

Impact of the Automobile Distribution Keiretsu on the Domestic and International Economy

Automobile manufacturers are benefitted several ways by keiretsu linked dealerships. The dealers assist car makers to assess the volume of cars which can be sold. The planning for production and sales is thus enhanced by the close ties with its dealerships. By having separate dealer channels for various models of cars, the car maker also can prevent dealers from concentrating their sales efforts only on the "high margin models" and ensure that all models will
be vigorously marketed (Yamamoto 1986, 25).

Keiretsu-linked dealerships also give the automobile makers more control over the number of cars each dealership is assigned to sell, and they help prevent individual dealers from discounting their products in order to increase sales. By offering bonuses to the dealerships for meeting their quotas, car makers can motivate the dealerships to vigorously pursue sales, and by granting exclusive sales rights in designated areas, they protect the dealerships ability to make these sales. The profit margin of both the automobile maker and the dealership is protected by not permitting discounting to customers to promote sales. In fact, the exclusive contracts between car makers and car dealers frequently prohibits dealers to discount their sales (Uzawa and Komatsu 1991, 174).

Another benefit of the distribution keiretsu arrangement in the automobile industry is that the quality of customer-oriented services can be ensured because of the direct and indirect supervision of car manufacturers. Both dealers and car manufacturers pay close attention not only to the market share of a particular car model but also to the service level which helps build confidence and trust of their customers. It is a common practice for car salesmen to visit former customers periodically to inquire about their satisfaction and problems that may have arisen with their cars. Such visits not only build customer confidence
in the product but also provide an opportunity to discover other potential customers among their friends or relatives. Complaints and suggestions are taken very seriously and referred back to the car manufacturers so that they can respond to the customers’ needs and make needed adjustments. The superior position of the Japanese automobile makers over their dealers also presents a number of problems and in some instances abuses of the dealers. Before 1979, forced sales goals were imposed on dealers through the sales contracts with automobile dealers, and if the sales quotas were not met, the car maker unilaterally could terminate the dealers’ franchise (Negishi 1990, 46). Furthermore, automobile makers often demanded "blank promissory notes" or pre-signed blank checks, making the dealers liable for the quotas imposed on them whether they were sold or not (Shimokawa 1985, 19). In 1979 the Fair Trade Commission (FTC) instructed the Japanese automobile makers to stop setting mandatory sales quotas for dealers and to replace them with sales targets. Furthermore they instructed the car makers to stop requiring pre-signed checks or blank promissory notes from dealers.

Despite these instructions from the FTC, automobile makers continue to pressure dealers to accept sales targets which in all but name only are the same as sales quotas although it is no longer required in the sales contract. Furthermore, most dealers still offer promissory notes or
pre-signed blank checks to cover expenses of the number of cars called for in the sales target, even though the provision has been removed that the car makers can unilaterally cancel dealers' exclusive franchise for failure to meet the sales target. The dealers' association reported in 1985 that automobile makers still largely dictate the sales volume required of dealers (Negishi 1990, 51).

Automobile dealers, despite their call for greater autonomy, have become more dependent on their car makers because of the manufacturers' marketing strategy which stresses acquiring a larger share of the market. This strategy calls for lowering the dealer's profit margin per car and using rebates to stimulate sales efforts of dealers. This marketing strategy worked to the advantage of both car manufacturers and the dealers during the period of high economic growth in the 1960s. Expansion of the market share by exclusive franchise system of dealers permitted both parties to prosper. But with the advent of lower economic growth since the late 1970s and a maturing demand for automobiles in Japan and abroad in the 1980s, the system of distribution through keiretsu firms, with an emphasis on low profitability per car for dealers and rebates for expansions of markets, has created serious financial problems for dealers. About 40 percent of Japanese automobile dealers since 1985 have suffered financial loss (ibid) despite the promise of rebates by automobile makers for additional
Many dealerships have been forced out of business as a result of these financial problems.

New car sales in Japan are dominated by the car manufacturers with established keiretsu networks. Introduction of new cars into the Japanese market whether by small domestic companies or foreign car manufacturers requires that these dealers create their own system of distribution. This is very expensive and risky because of the extremely high price of land in Japan and the need to establish separate service facilities for their cars. Although there exist some independent car dealers for imported cars, their distribution outlets and service facilities are very limited and not nearly as extensive as keiretsu dealers of major Japanese car makers. All Japanese automobile makers until the late 1970s had contractual provisions preventing their dealers from handling other automobile makers' cars. Although such provisions were required to be removed from contracts by the FTC in 1979 (ibid, 41), in practice Japanese automobile makers continue the practice of having dealerships devoted to selling mainly their cars (Uzawa and Komatsu 1991, 179). Since the bigger Japanese automobile makers have more extensive networks of distribution keiretsu, they are largely able to keep competitors cars out of the market.

The FTC, the antitrust regulator in Japan, has interpreted the anti-trust law in such as way as to prevent
it from intervening in distribution keiretsu practices as long as the member firms are autonomous and theoretically can sell cars of other automobile makers. They hold that the market is free as long as other automobile companies are free to establish their own distribution systems (Negishi 1990). Thus, mere linkage in a keiretsu cannot be regarded as a violation of the anti-trust law. On the other hand, if car dealers are tied with the automobile makers through stock ownership or other financial ties or through arrangements of sharing managerial personnel, there may be a violation of the anti-trust laws (ibid, 43). If automobile dealers exclude competitors' cars as a result of these types of linkages, there is a possibility of intervention by the Fair Trade Commission (ibid). In reality, the FTC has not vigorously enforced these provisions.

Japanese automobile makers were forced to open up their distribution systems to foreign cars as a result of this regulatory ruling by the FTC and the increased political tensions about the automobile trade imbalance between Japan and the West, especially the United States. Placing foreign cars in the lots of their dealers, however, did not alone guarantee more sales. The American argument for increasing sales led in 1992 to a bilateral meeting between President Bush and Prime Minister Miyazawa in which the Japanese automobile makers, including Toyota and Nissan, agreed to make an effort to sell more American cars through

Even though foreign cars are to be accepted on dealers’ lots, there still may be little incentive for the keiretsu dealerships to sell them since the parent company continues to pressure their dealers to focus sales on their own cars. The recent depressed economic condition in Japan further aggravates the situation since sales generally are declining. Since the bilateral meeting of President Bush and Prime Minister Miyazawa, the main argument has centered on the annual sales goal of Japanese car makers with their dealers. American car makers want the Japanese car makers to include the sale of more American cars in their sales goals with their dealers. Japanese car makers in the face of declining domestic sales are less inclined to pursue the target set for American cars.

The low rate of penetration of American cars into the Japanese market is caused by both American car makers’ inability to distribute cars through keiretsu dealers and the reputation of not being competitive in price or quality. Obviously having to depend on their competitors’ marketing system places Americans at a great disadvantage. To overcome both of these hurdles, American car manufacturers in the long run probably will have to build a new distribution system on their own while relying in the short run on political pressure on Japanese car makers to meet their agreed upon sales target. At the same time they need
to find a way to overcome the public perception that their products are higher in price and poorer in quality than Japanese cars.

Recent Changes in the Automobile Distribution Keiretsu

Demand for new cars in Japan weakened in the 1970s as a result of the economic downturn following the Arab oil embargoes and in the 1980s as a result of the saturation of the domestic market for automobiles. As sales of keiretsu dealers fell, the marketing strategy of Japanese automobile manufacturers which provided for a low profit margin per car for dealers, plus rebates for greater sales efforts, became increasingly ineffective at generating sales and proved financially harmful to car dealers. Since total sales declined in the mid 1980s, about 30 percent of all Japanese automobile dealers have suffered losses as their normal earning from sales without rebates is not enough to generate a profit (MITI 1987, 21). Almost 15 percent of large dealers with more than 500 employees suffered deficits and 38 percent of smaller automobile dealers with less than 100 employees also reported losses in 1985 (ibid). In face of the financial crisis among car dealerships, major Japanese automobile makers attempted to consolidate or reduce the number of dealerships and began to grant them greater autonomy over cars they could sell that they could earn revenues from other sources. Through these efforts car
makers attempted to distance themselves from some of their responsibilities to the keiretsu firms. The traditional spirit of keiretsu of caring for its members was seriously strained by these changes. Even Japan's top automobile maker, Toyota, has reduced the number of dealers for five of its models as shown in Table 12.

Table 12. Number of Toyota Keiretsu Dealers

<table>
<thead>
<tr>
<th>Toyota Motor Divisions</th>
<th>1985</th>
<th>1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>Toyota</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Toyopet</td>
<td>52</td>
<td>52</td>
</tr>
<tr>
<td>Vista</td>
<td>67</td>
<td>66</td>
</tr>
<tr>
<td>Corolla</td>
<td>81</td>
<td>71</td>
</tr>
<tr>
<td>Toyota Auto</td>
<td>68</td>
<td>66</td>
</tr>
</tbody>
</table>


Many automobile dealers in an effort to reduce their overhead expenses also have altered their sales efforts from door-to-door to showroom sales at the dealership. This change in the sales technique recognizes the labor intensive nature of door to door sales, as well as the changes which are occurring in Japanese society. The number of Japanese families where all family members work outside the home has expanded greatly, making door to door sales increasingly ineffective (Uzawa and Komatsu 1991, 80).

Dealers increasingly are attempting to attract potential customers to their showrooms by locating them near facilities which attract people, such as restaurants, motor
parts or equipment shops, etc. (ibid, 180). Automobile makers and their keiretsu dealers also have started to set up showrooms for demonstrating their car models in major cities throughout Japan. Nissan Motor’s keiretsu dealers, for example, have jointly installed general automobile showrooms called Apleet in most major cities for demonstrating their new lines of cars. Most often, these displays are located in shopping centers or other places where there is a large traffic of people (ibid, 181). Toyota Motors has followed suit with its own company showrooms, as have many other of the smaller car makers. Unlike Nissan’s dealers’ showrooms, Toyota’s demonstration facilities are manufacturers’ showrooms only to generate interest and to refer prospective customers to their dealers (ibid). The major automobile makers also have begun to make available facilities in the existing automobile sales showrooms in Tokyo to American cars as the initial stage of sales promotion (Nihon Keizai Shimbun January 10, 1992, 6).

Another major change in the distribution of automobiles in Japan occurred during the 1980s as new automobile distribution channels, especially for foreign cars, were added either through independent dealers or the keiretsu dealers of automobile makers. Many of the new outlets for foreign cars were established as a result of independent firms or individuals importing foreign cars directly from overseas dealers rather than from foreign car makers.
Through this practice, these new firms are able to evade provisions of the exclusive sales contracts between foreign car makers and their Japanese importers and dealers. Increased competition was created among car dealers by this development. Sales by these new dealerships has grown to about 16 percent of all sales of foreign cars in the country since the late 1980s (Uzawa and komatsu 1991, 205). The exclusive agents for sale of foreign cars in Japan, such as Yanase and Kintetsu motors, have been impacted most directly by this development. Also, smaller Japanese automobile makers, whose dealers are suffering from lack of sales, were influenced to permit their dealers to sell foreign cars obtained in this manner. German-made cars, such as Mercedes Benz and BMW, especially have been attractive to these dealerships. The broadening of the scope of sales for these keiretsu dealerships appears to be changing the exclusive nature of relationships between dealers and the parent car makers, and to be weakening the practice of not handling any but their own manufacturers' vehicles.

The new competition to sell foreign cars also has encouraged foreign car makers to seek means of getting out of the exclusive contracts with their Japanese agents. Foreign automobile makers in the mid 1980s, especially the Germans, began terminating exclusive import and sales contractual provisions with Japanese importers so that they could open their own distribution channels in Japan.
Success of the German car makers in breaking these provisions and establishing their own outlets proved to be quite profitable since they captured about 52 percent of the 182,984 foreign car market in Japan in 1989 (Oishi 1990, 25). German automobile makers also have entered contracts with Mitsubishi Motor Company and several other smaller car makers to distribute their cars through their keiretsu dealers (Terayama 1990, 43). Despite these arrangements and the creation of their new independent sales outlets, the sales networks of keiretsu dealers of major domestic car makers still dominate the foreign car market in Japan. All foreign automobile makers still are largely dependent on keiretsu dealers to sell the majority of their cars.

Economic recovery of the Japanese car market by the mid 1980s showed foreign car makers that there is a large potential market for foreign cars in Japan. The belief that there is a larger potential market is supported also by the fact that Japanese automobile makers generally are entering into contracts to sell foreign cars through their own dealers. For example, Isuzu Motor is now selling General Motors and Adom Opel AG cars from Germany through 60 percent of its dealers (The Japan Economic Journal 1989, 19). American General Motors and French Peugeot cars are distributed through Suzuki dealers (ibid) and dealers of Mazda Motor sell Ford cars through a separate distribution system called Autorama Inc. in 1982 (Katz 1989, A1). Toyota
Motor also has entered the foreign car marketing business and has begun selling Volkswagen and Audi cars in the spring of 1992 through a new distribution channel created to sell only foreign cars (Nishino 1991, 10).

The popularity of foreign cars in Japan by 1990 leveled off, and in fact declined, as the economy slowed. Whereas the growth rate of sales of imported cars had increased 35 percent each year from 1986 to 1989, by 1990, the rate of growth had slowed to about 25 percent, and the total number of foreign cars reached 230,000 or 5.4 percent of the total number of automobiles sold in Japan (Oishi 1990, 25).

The growing political tension between Japan and Western countries due to an increasing trade imbalance has led the Japanese government to encourage the automobile industry to import more foreign made cars. As a result of the administrative guidance or "Gyosei Shido," by the Japanese government, some major Japanese automobile makers began a program of importing Japanese nameplate cars produced in the North America. This program of importing Japanese nameplate cars from North America is aimed at increasing the volume of imports of foreign made cars, while at the same time respond to consumers' demands for greater variety in choice of cars. Honda Motors, for example, began to export their cars made in North America to Japan in 1988. The idea of the reverse import which is based on the concept of "development import" or "kaihatsu yunyu" is that Japanese
manufacturers abroad are to produce industrial products specifically aimed at the Japanese market according to their specifications (Lincoln 1990, 129). Although major portions of the "development imports" by Japanese manufacturers abroad have been on industrial products which are heavily dependent on energy or other natural resources, as well as clothing and canned food products (ibid), the Japanese automobile makers in North America foresee an increase of imports of their nameplate cars. By increasing the number of reverse import cars, Japanese automobile makers could help reduce the political pressures over the trade imbalance, as well as meeting the pledge to increase sales of American made cars. The ratio of reverse imports of cars into Japan, however, still is low in comparison to the exports of Japanese cars to North America.

Although there have been changes in the distribution keiretsu and the methods of distributing foreign cars in the Japanese market, the change does not necessarily guarantee increased sales of the "Big three" American makers, General Motors, Ford and Chrysler. These car makers as still largely dependent on Japanese keiretsu dealers, whereas German car makers have developed much of their own distribution system. Whether or not the cars of America's "Big Three" sell in Japan still depends not only on the potential demand of the Japanese consumers but also on their domestic rivals who dominate the keiretsu system through
which sales are made.

Despite the fact that American cars now are accepted for sale on the lots of many of the keiretsu dealers, Japanese car makers consider German cars, rather than American to be their real competitor since they control much of their own distribution system. Doubt about the competitiveness of American cars is often expressed by the leaders of both government and automobile makers in Japan. Evidence of this can be seen in the fact that soon after the bilateral agreement in January 1992, Japanese automobile leaders were quick to announce that the target of 20,000 American cars a year was only a target, not a promise (Rafu Shimpo January 25, 1993, 5).

Price is another disadvantage for marketing foreign cars, especially American made vehicles, in Japan (Tokyo Business Today 1990, 30). A comparison of the price of foreign cars in Japan and other markets was undertaken in 1989 by a joint survey of the United States and the Japanese government. According to this study, the price of a Ford Taurus LX in Tokyo was considered to be 100 on a scale and comparative prices of the same model were calculated for other markets. The price of these cars in New York was 55.8, in Chicago, 52.7, whereas in Osaka, Japan it was 99.3 (Uzawa and Komatsu 1991, 196). German cars also were more expensive in Japan, although the difference in cost in American and Japanese markets was less. For instance, the
price of a BMW 735i in Tokyo on the scale was 100, but the price in New York was 84.4, in Chicago 87.0, and in Osaka, Japan 101.5 (ibid). There was not nearly as much difference in the price between Japanese nameplate cars, such as Honda, in the American or Japanese markets in 1989. For instance the price of an American made Honda was found to be 100 in Tokyo and Osaka, Japan and 94.2 and 94.4 in New York and Chicago respectively (ibid).

The difference in volumes of sales of foreign cars in these markets is considered to be the decisive factor in this price difference. Only 521 Ford Taurus LX and 1,208 BMW 735i were sold in the Japanese markets in 1989 (ibid). As long as the volume of sales of cars is this small, each foreign car sold in Japan bears a large share of the maintenance and handling fees, plus personnel and advertisement charges which push up the total cost of the vehicle (ibid).

Japanese safety standards and licensing procedures on imported cars also have helped to push up the cost of foreign cars in the past. Foreign car makers and their governments claim that the Japanese require unneeded time consuming customs and expensive procedures in their safety and emission standards. Increasing political pressures on the Japanese government has led them recently to begin simplifying their import procedures. This change in import procedures helped reduce much of the friction between the
countries and lessened the costs of American firms trading with Japan.

The traditional pattern of automobile distribution keiretsu remains strong in Japan despite these recent changes. Rather than accepting cars of foreign competitors into their existing keiretsu auto dealers, many Japanese car makers, especially the larger companies, have tended to create new distribution channels for imported cars. As a result, Japanese automobile makers with foreign distribution systems are the major importers of foreign cars rather than independent dealers. Imported foreign cars by the Japanese automobile makers are distributed mainly through their new distribution outlets although some are sold through independent firms. The domestic keiretsu firms continue to sell mainly cars of the parent company. This is also true for domestic-made cars by other manufacturers. For example, Toyota dealers still can sell neither Nissan cars in their dealer shops, nor models of their own new cars through dealership of other manufacturers.

Distribution keiretsu dealers have had to change their way of doing business as a result of the outside pressures on them. Increasing competition and declining markets have made it increasingly difficult for dealerships to rely on only the sales of new cars of their parent automobile makers. Many have been forced to begin selling used cars in conjunction with the new car business. Sales of used cars
by new car keiretsu dealers rose to 35 percent of such dealership by the early 1990 (ibid, 187). Also many keiretsu dealers, especially the smaller automobile makers have begun to sell foreign cars imported directly from foreign car dealers. Many dealerships have been forced to reduce overhead expenses and had begun to depend on showroom sales rather than the traditional door to door sales. All of these changes have tended to make the keiretsu dealership more like an autonomous business.

Summary

Like production keiretsu, the pattern of automobile distribution keiretsu has changed in recent years although the basic pattern remains intact. The pattern of hierarchical ties between an automobile maker and dealers in the distribution keiretsu remains strong. Automobile makers continue to hold a superior position over its dealers despite the modifications of the power balance between them.

There continues to be both benefits and burdens for dealers in distribution keiretsu. The main benefit of being a keiretsu dealership is the availability of financial and management assistance from the parent company. The major drawback or cost of being a keiretsu firm today is that dealers have less autonomy over purchases or sales of cars and are unable to diversify by selling foreign or domestic cars made by other manufacturers.
The nature of the contractual relations between the parent car manufacturer and the dealerships in a distribution keiretsu make monopolistic tendencies more visible than in a production keiretsu. Japanese car makers, because of the visibility of their relations with distribution keiretsu, have been subjected to intense criticism and governmental scrutiny by the FTC. For example, they were forced to modify the contractual provisions against handling cars made by competitors. Foreign criticisms of automobile distribution keiretsu were lessened somewhat by the FTC's mandate to remove provisions against selling competing manufacturing cars and also by the development of arrangement with Japanese automobile makers to distribute foreign-made cars through either their keiretsu dealers or through separate channels.

Independent and foreign owned dealerships remain at a disadvantage since they do not have an extensive parts and customer service shops as keiretsu dealers. As a result, owners of cars made by other manufacturers have difficulty getting parts and repairs made promptly. Foreign cars have made some gains in penetrating the Japanese automobile market as more dealerships are handling their vehicles. They still, however, face major obstacles. Most serious perhaps is the fact that they do not control their own distribution outlets. They also have a major public relations problem in that there is a widely-held perception
by the public that foreign cars are more expensive and lower in quality than Japanese made cars.

Production keiretsu have changed less fundamentally than distribution keiretsu because of the greater mutual dependency between the parent car maker and the parts makers. This is especially so for the first tier keiretsu firms producing strategic automobile parts. The well-being of both parties in the production keiretsu depends on each other. Furthermore, production decisions are not as open to public scrutiny as the actions of distribution keiretsu. Production keiretsu as a result have not drawn as much criticism over their structural arrangement from the Japanese government. The government, on the contrary, tolerated or even encouraged formation of production keiretsu to make the automobile industry competitive in the 1960s. Government, in fact, often reacted against capital and trade liberalization in the Japanese market by suggesting mergers of domestic car makers in order to make the industry stronger. The production keiretsu recently, however, have been subject to intense criticism by foreign car makers and their governments because they prevent purchases of automobile parts from non-keiretsu bidders.

In an attempt to lessen the political conflict over the growing trade imbalance, Japanese car makers have taken the initiative recently to import more foreign cars. Not only have they agreed to a target for selling American cars, but
they also have begun to encourage reverse imports of Japanese nameplate cars produced in North America. As to date, the tide has not turned in the American trade imbalance since only very few foreign cars are sold in the Japanese market.
CHAPTER V

PRODUCTION AND DISTRIBUTION KEIRETSU IN THE JAPANESE HOME ELECTRIC APPLIANCE INDUSTRY

The home electric appliance industry, similarly to the automobile industry, has grown very rapidly, capturing a large part of the world market. Its success has caused intense competition and political and economic tensions with competing firms in other nations, especially in the United States. As a result, the network of keiretsu in this industry has been a subject of much discussion. Televisions and semiconductor products used in a host of electronic products has created international trade problems not unlike those involving the automobile industry. The first section of this chapter describes the production keiretsu in the home electric appliance industries. The second section then examines the distribution keiretsu.

The electric and electronic industry has evolved from two major business focuses: the production of home electric appliances, such as refrigerators, stoves, vacuum cleaners, etc., and the production of industrial electric equipment, such as motors, tools, robots, X-ray equipment, and more recently personal computers. This industry has become the major focus of the political tensions between Japan and the United States. Table 13 shows the composition of the
electric and electronic industry.

Table 13. The Electric and Electronic Industry

| Electric Appliance Manufacturers. e.g., Refrigerators, Vacuum Cleaners, etc. |
| Home Electric Appliance Industry 
| Electronic Manufacturers. e.g., Microwave Ovens, Televisions, Radios, Videos, Audio Equipment, Personal Computers, and Semiconductors. |

The Electric and Electronic Industry


Source: Compiled by author from Itoh 1987, 164; Kobayashi 1981, 58; Nakae 1979, 27.

The home electric appliance industry may be divided into two types of firms, namely those producing electric appliances and those manufacturing electronic equipment. Appliance manufacturers produce such products as washing machines, vacuum cleaners, home electric heating equipment, and microwave ovens (Wakasa 1984, 20-21). Home electronic appliance manufacturers make televisions, radio receivers, stereos, video tape recorders, and the component parts of
personal computers.

Firms in the electronic appliance field have assumed leadership in the home electric appliance industry. Today about 70% of the total business of the industry comes from electronic equipment and the percentage continues to increase (Ito 1987, 164). Within the electronic appliance business there are two major categories of firms, those emphasizing production of audio equipment, such as radios, stereophonic sound systems, tape recorders, tape decks and disk, juke boxes and the modern version Karaoke music boxes, and those manufacturers which stress manufacturing audio visual equipment, such as televisions and video cassettes recorders. Relatively few companies dominate both of these industrial fields. The major firms emphasizing audio equipment are Pioneer, Trio, Japan Columbia, Aiwa, Crown, Tiack, Akai, Sansui Electric Company, etc. (Wakasa 1984, 23). The major firms emphasizing audio visual products are Matsushita, Sony, Japan Victor, and Kotobuki Electronics Industry Ltd. (ibid, 22).

The home electric appliance field is characterized by an oligopolistic arrangement of eight major manufacturers. The big three, Matsushita Electric, Sanyo, and Toshiba control over 50% of the domestic market for home electric products. The top five, with Hitachi and Sony added to the big three, dominate 69.7% of the market; and the top eight, with Sharp, Japan Victor, and Mitsubishi Electric, command
93% of the domestic home electric appliances market (Ito 1987, 164). All of these firms, as well as those emphasizing the electronic side of the home electric appliance industry, have networks of keiretsu firm in the production and distribution of their products.

Production Keiretsu in the Japanese Home Electric Appliance Industry

Structurally, production keiretsu in the home electric appliance industry are similar to the production keiretsu in the automobile industry. Manufacturers of both electric and electronic products purchase a large percentage of parts from keiretsu firms rather than manufacturing them in their own facilities. The larger electric appliance makers purchase a higher ratio of parts outside their companies from keiretsu and non-keiretsu firms. The ratio of parts purchased from outside firms in the Japanese electric industry as a whole was 57.9% in 1981, while for larger electric firms with over 300 employees, the ratio of parts purchased outside was above 90% (Takada 1989, 110). A major reason for this greater purchasing of parts by larger firms is that they have more extensive production keiretsu networks from which to obtain essential parts.

Production keiretsu in the home electric industry, like keiretsu in the automobile industry, also rely on a subcontracting system with multiple levels of firms.
producing parts. There are thousands of part manufacturers working as subcontractors for a parent electric or electronic firm. The same hierarchical division of work based on the subcontracting system is found in the production keiretsu of the home electric appliance industry as in the Japanese automobile industry. Table 14 shows the structure of a television production keiretsu for a large electronic firm and an estimate of the number of keiretsu firms at each level or tier.

Table 14. Television Production Keiretsu for a Large Home Electric Appliance Company

<table>
<thead>
<tr>
<th>Level</th>
<th>Number of Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>A parent company</td>
<td>1 company</td>
</tr>
<tr>
<td>1st tier subcontractors</td>
<td>Approx. 42 companies</td>
</tr>
<tr>
<td>2nd tier subcontractors</td>
<td>Approx. 400 firms</td>
</tr>
<tr>
<td>3rd tier subcontractors</td>
<td>Approx. 4,000 firms</td>
</tr>
</tbody>
</table>

Note: ➔ indicates direct business transactions.
Source: Adapted from Takada 1989, 113.

First-tier part suppliers are more closely linked with the parent firm since they produce or assemble vital production parts for the parent company. They usually assemble key semi-finished parts into production units. Second and third line subcontractors are mainly smaller businesses which manufacture such items as bolts and nuts,
washers, springs and castings or undertake such industrial processes as pressing, cutting, and coating parts for the first-tier keiretsu firms (Takada 1989).

The pattern of subcontracting in the home electric appliance industry, however, is more loosely organized than that in the automobile industry. The relationships between a parent electric or electronic appliance maker and its subcontractors are not as close or intimate as in the automobile industry. These are two reasons for this lack of closeness between the parent firm and the first-tier keiretsu firms in the home electric appliance industry. First, a greater variety and diversity of parts and products exists, and secondly, a greater amount of standardization of parts used by all electric or electronic appliances makers is practiced.

The variety of products produced by a giant firm like Hitachi may range from audio visual products, such as stereo systems and video cameras, to home appliances, such as refrigerators, washing machines, and microwaves, as well as to "industrial turbines, generators, semi-conductors", and laptop mainframe computers (Aoki 1988, 237). Components and parts for this multitude of appliances are clearly very diversified. The system for contracting for these parts, therefore, is multi-divisional, involving subcontracting groups for each specific product. The production keiretsu, therefore, is not as intimately involved in helping to
develop the parent company's products as in the automobile industry, where first-tier keiretsu firms working with the parent manufacturer help produce strategically important parts for automobiles (ibid). Electric or electronic appliance parts, on the other hand, are mostly standardized throughout the industry. For example, parts for such home electronic appliances as television sets are largely standardized and the same part is used by all manufacturers (Matsui 1988, 17). As a result of standardization, there are more independent parts suppliers in the home electric industry, especially in the electronic appliance industry. Independent parts makers are better able to compete and sell standardized electronic parts to different electronic makers.

Large home electric appliance makers such as Matsushita, Hitachi, and Toshiba generally obtain electric parts from their keiretsu subcontractors or their own in-house production facilities, although they also may buy parts from independent specialized parts makers. The technologically intensive components, such as picture tubes, semiconductors, and integrated circuits are generally produced by the parent manufacturing company (Tsuruoka 1980, 73). General electric parts, including the components of electric circuit such as resistors, condensers, and transformers, and the components of mechanical equipment, such as switches, tuners, and printed circuit boards, are
manufactured either by keiretsu firms or by specialized non-
keiretsu parts makers (ibid). These specialized parts
makers are usually middle sized independent firms with a
capital investment of one million yen or more (ibid).
Because of the greater standardization of parts, the parent
company in the home electric industry is not as concerned
with the diffusion of technology as in the automobile
industry. Therefore, there is less reason to form rigid
production keiretsu ties between the parent manufacturer and
their parts subcontractors as in the automobile industry.
As a result, parts makers in the home electric industry
often serve several manufacturers.

The parent manufacturers of electric or electronic
appliances often create cooperative association of parts
makers or "kyoryoku kai" as a means of providing
technological, financial, and managerial assistance to its
keiretsu firms. Although these kyoryoku kai are similar in
principle to those in the automobile industry, they differ
in that membership is frequently subject to change whereas
change is rare in the cooperative associations of the
automobile industry. For example, one large home electric
appliance maker changes 3% of the member firms in the
cooperative association every year to create competition
among keiretsu firms (Minato 1989, 6). Since over a half of
all orders for parts by the manufacturers of home electric
appliances go to members of the cooperative association
(ibid), it is important for the keiretsu companies to maintain these ties to the parent company.

Another characteristic of the production keiretsu of the home electric appliance industry is that a majority of subcontractors are small or medium-sized enterprises. Ninety-eight percent of the 32,447 enterprises in the electric appliance manufacturing field have fewer than 300 employees (Takada 1989, 110). Unlike the automobile industry, where the first-layer parts suppliers consist of large firms, the production keiretsu in the electric industry is made up mostly of small and medium-sized part makers. For example, most first-tier subcontractors attached to a television division of a home electric company normally consist of firms with 50 to 100 employees (ibid, 110, 113), and they mainly assemble key semi-finished parts into production units for the parent company. The first-tier subcontractors contract out the simple processing and manufacturing of parts to second-layer subcontractors which are smaller business enterprises normally with less than 20 employees (Tsuruoka 1980, 74). Most of the subcontractors in the home electric industry, even the first-tier keiretsu firms, are involved in labor-intensive type of work even though it may be technologically sophisticated. Ninety-eight percent of the total 32,447 enterprises in the electric appliance manufacturing field are small and medium-sized enterprises (Takada 1989, 110).
Formation of Production Keiretsu in the Japanese Home Electric Appliance Industry

Production keiretsu in the home electric appliance industry have grown concomitantly with the industry since the 1950s. As the parent manufacturers grew, they spun off various departments of their businesses into independent subsidiaries or sub contractors. At the same time, they assisted small businesses with whom they contracted to develop so that they could accept larger and more complex assignments. Often the parent company provided technological, financial, and managerial assistance so that existing subcontractors could modernize equipment and facilities and improve the quality of products. The parent firms also helped form an organization of cooperative factories called "kyoryoku kojo" so that they could work better together and function as a part of the parent company.

There have been at least four stages in the development of the production keiretsu in the home electric appliance industry. In the first stage, from 1950 to 1963, parent firms were competing with other appliance manufacturers for a larger share of the rapidly growing electric and electronic appliance market (Takada 1989, 117). Relations between parent firms and their subcontractors were very close in this period as parent companies were nurturing and
guiding the subcontractors since they needed greater production capabilities. In this period, assistance from the parent firm was shared by subcontractors at all levels, although the first-tier firms received major assistance from the parent company. Since the first-tier firms needed the subcontractors below them, they in turn assisted the tiers of firms under them to develop greater capacities (ibid).

From 1964 to 1970, the parent companies began to be more selective in choosing lower level subcontractors. This reorganization of lower layered keiretsu firms emphasized quality and efficiency and the less efficient part suppliers were weeded out of the keiretsu. For example, Matsushita Electric Company ranked its subcontractors in 1963; only the most promising firms were given technological, financial, and managerial assistance and also were lent equipment to enhance their productivity. The less promising firms were let go. A major reason for the reorganization was to enhance the technological level of keiretsu firms since a majority of subcontractors relied on the parent firms for technological assistance (ibid, 116).

As competition increased among subcontractors between 1971 and 1973, parent manufacturers also faced major changes in the world market. More new technological sophisticated electronic products were being developed which required higher standards. These new market demands forced electric and electronic manufacturers to improve the quality and
technology of their products.

After 1974, parent manufacturers continued to be impacted by economic pressures resulting from the oil embargoes and the changes in the market for electric and electronic appliances. To cope with fluctuations in the economy, along with diminished domestic demand for color televisions, all electric and electronic manufacturers attempted to reduce costs by automation of the production processes. Rationalization in production in terms of increased automation increased by 62% from 1975 to 1979. Production techniques were changed and the number and cost of parts reduced. For example, in the manufacturing of color television set, the introduction of integrated circuits and integration of parts reduced production time, the number of needed parts, and the number of defects by 65% in the four years from 1975 to 1979 (ibid, 123). As electronic manufacturers were modifying and re-tooling their own facilities, they tended to distance themselves from keiretsu firms both at the lower levels of suppliers and at the first-tier level of subcontractors. Increasingly, parent manufacturers attempted to reduce reliance of keiretsu firms on them. Matsushita Electric Company, for instance, instructed its subcontractors to diversify and to reduce their business dependence on the parent firm from the 60% level in 1987 to 30% in the future (ibid, 116). The stages in the development of keiretsu in the home electric
Appliance industry is summarized in Table 15.

Table 15. Stages of Development of Production Keiretsu in the Home Electric Appliance Industry: 1955 to 1993

<table>
<thead>
<tr>
<th>Period</th>
<th>Developmental Phases</th>
<th>Relationship between Parent Firms and Subcontractors.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955-1963</td>
<td>Formation of the production keiretsu by fostering and nurturing subcontractors.</td>
<td>Very close through initiation and guidance of the parent companies toward whole subcontractors.</td>
</tr>
<tr>
<td>1964-1970</td>
<td>Streamlining and reorganizing subcontractors, especially lower-tier subcontractors.</td>
<td>Close ties through nurturing and guidance to selected subcontractors.</td>
</tr>
<tr>
<td></td>
<td>Preferential treatment was given to cooperative suppliers.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Objective to bring subcontractors to a higher standard.</td>
<td>Permitted subcontractors to diversify.</td>
</tr>
<tr>
<td></td>
<td>Inefficient subcontractors were weeded out.</td>
<td></td>
</tr>
<tr>
<td>1974-present</td>
<td>Continued reorganization and automation in industry.</td>
<td>The parent firms distanced themselves from subcontractors. Keiretsu relationships increasingly loose except for a few first-tier firms.</td>
</tr>
</tbody>
</table>

Source: Adapted from Takada 1989, 119.
The international competitiveness of the Japanese home electric appliance industry depends on the structural characteristics of the industry. Production keiretsu in this industry have functioned as an organizational means of dividing tasks or functions with a parent manufacturer at the top and multiple layers of subcontractors working under it. This method of organization assures that firms in the production keiretsu are responsive to the needs and suggestions for change by the parent company (Baranson 1981, 125). The keiretsu structure also promotes development of new innovations and products by providing a means of funding research and development through major keiretsu banks. These banks, because of the keiretsu ties, are able to take greater risks on new firms and products, and in turn keiretsu firms can be more innovative. For instance, Sumitomo Bank which is the major bank of the Sumitomo keiretsu provided developmental funds to a promising computer company, Nippon Electric Company, (NEC) so that it could get underway. Because of the closeness of keiretsu relations, keiretsu banks are more willing to help firms and do not require Western-style financial analysis of fellow keiretsu members (Neff 1992, 32). Evidence of the innovation of keiretsu firms is seen in the fact that
Japanese electric firms manufacture a wide range of electric and electronics goods, ranging from home and industrial electric products to computers.

The keiretsu structure also enables manufacturers to control costs better than a conglomerate or bureaucratic type of organization. Since keiretsu firms are not an integral structural division of the parent company, various adjustments to reduce costs may be imposed on firms in the keiretsu by the parent company. This is one reason for the international competitiveness of large Japanese firms, whether they be electric or automobile firms. The parent firm literally can mandate cost reductions which the subcontractors have to follow. An example may be seen during the inflationary period after the oil shocks of the 1970s when 80% of the electric component subcontractors were ordered to lower prices for the parent manufacturer to remain competitive in the international market (Tsuruoka 1980, 78).

Electric production keiretsu, like those in the automobile industry, also use a number of management techniques, such as the just-in-time and zero-defect quality control which helps restrain costs by reducing production time and space requirements, plus lessening the cost of repairing defects. These cost containing managerial practices depend upon close geographic proximity with the parent manufacturer and frequent and regular communications
throughout the keiretsu network.

Quality control in keiretsu firms, through the zero defect production technique, reduces overall production costs for the parent manufacturer since they rely on pre-inspection arrangements with their suppliers, and they do not have to undertake separate inspections. The zero defect production system also benefits the subcontractors as the number of costly defects in production are reduced by the workers themselves without additional inspectors. This quality control system reduced the amount of reworking of televisions during production in 1979 to 0.8 man hours per unit in Japan versus 2.6 man hours in the United States (Congress of the United States Office 1990, 92). Furthermore, evidence of the effectiveness of the system can be seen from the fact that there were twice as many service calls for American-made color televisions in 1979 as for Japanese-made color televisions (ibid). The increased reliability of televisions freed Japanese firms from having to support dealer networks in the United States to service their products.

There are, however, some negative aspects of the organizational structure of production keiretsu. Ties between the parent manufacturer and its subcontracting suppliers tend to create intense competition among rival keiretsu suppliers and to reduce the amount of business available for independent domestic and foreign suppliers.
The exclusive purchase of parts by parent manufacturers from production keiretsu firms, however, are less common in the home electric parts industry than in the automobile industry. As long as non-keiretsu companies, whether domestic or foreign, retain a competitive price and quality, they may overcome the structural barriers of keiretsu and obtain orders for parts from electric and electronic manufacturers. This is due to the fact that parts are more standardized in the industry. The United States government and American home electric appliance makers in the bilateral discussions of 1992 apparently recognized the possibility of competing in the semiconductor market as they demanded at least a 20% market share for American products in Japan. Although the Japanese government agreed to this demand, it failed to meet the goal in 1992, so the arguments continue.

Keiretsu parts suppliers have less autonomy in operating their businesses than independent firms, especially in periods of economic downturn when the parent manufacturers may dominate their destiny. The more they rely for business on the parent firm and the less diversified they are, the more they are subject to control by the parent company. Parent firms threatened by economic recession are likely to require keiretsu firms to take much of the financial blow by either reducing the amount of business given to their keiretsu firms or by mandating lower cost of their parts. When business is poor, parent
manufacturers may even decide that it is too costly to support all members of the keiretsu and that some must go. Such conditions are a reason why parent electric firms recently have begun to support increasingly fewer keiretsu suppliers. Furthermore, many parent firms have informed their keiretsu subcontractors that they must become less reliant on them for their business. Increasingly, more firms are being cut loose from keiretsu support. Matsushita Electric is a good example in that it has informed its subcontractors that they should reduce their reliance on contracts from the company from 60 to 30%.

The just-in-time management technique required by parent manufacturers may work to the detriment of parts suppliers in the electric and electronic industry just as it does in the automobile industry. In fact, since there are many more parts in the electric and electronic industry, the parts suppliers are forced to either retain larger inventories or to invest in several kinds of additional tools and equipment to give them the ability to meet the parent company's time requirements. A subcontracting firm of Hitachi reported that after adoption of the just-in-time supply system the company had to acquire several additional production molds in order to meet supply requirements (Tsuruoka 1980, 79). Adaptation to the just-in-time production schedules, the firm claims, means transferring responsibilities for inventories from the parent
manufacturer to the subcontractors (ibid, 79-80). Minimizing inventory at the parent company is compensated by the increase of inventories at the subcontracting firms (ibid).

As can be seen from these examples, production keiretsu mainly aid the parent manufacturers, especially during economic downturns, and they may be harmful to subcontracting firms.

Distribution Keiretsu in the
Home Electric Appliance Industry

Distribution in the home electric appliance industry, like distribution of automobiles, is undertaken through multiple layers of distribution outlets. Table 16 shows the distribution outlets of the home electric appliance industry.

Electrical and electronic products are distributed from manufacturers to consumers through the manufacturer’s designated wholesalers and retailers. Traditionally, products of this industry, except audio visual equipment such as stereo and tape disks, were distributed almost exclusively through keiretsu retail stores via territorial based keiretsu wholesale companies (Nishino 1991, 86). More recently, appliance manufacturers have begun to sell directly via their wholesalers to large volume independent retail outlets, including supermarkets and departments.
stores which carry products of a number of different manufacturers.

Table 16. Distribution Outlet of the Home Electric Appliance Industry

<table>
<thead>
<tr>
<th>Manufacturers</th>
<th>Wholesalers</th>
<th>Retailers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home Electric Appliance Manufacturers</td>
<td>Manufacturer's Sales Promotion Companies</td>
<td>Keiretsu Retailers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other Independent Retailers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Large Volume Retail Electronic Stores</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Consumers</td>
</tr>
<tr>
<td>Home Electric Appliance Manufacturers</td>
<td>Manufacturer's Sales Promotion Companies</td>
<td>Large Volume Retail Electronic Stores</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Supermarkets and Department Stores</td>
</tr>
</tbody>
</table>

Source: Adapted from Yamana 1992, 198.

Development of large volume retail electronic stores, supermarkets, and department stores challenged manufacturers' control over prices of their products. These outlets regularly use discount and loss leader pricing to attract customers which conflicts with traditional pricing practices where manufacturers and their wholesalers control prices of retailers. Large volume stores recently were challenged by the appliance manufacturers for discounting products, and the Fair Trade Commission sided with the large
volume stores' claim that forbidding discounting by these stores was a violation of the anti-monopoly law. Although discounting is now prevalent in the larger independent stores, keiretsu retail outlets still may not discount prices of products to their customers (Wakasa 1991, 139). Inability to be competitive with large retailers seriously threatens keiretsu firms and has forced manufacturers to provide other types of financial incentives to them such as discounts on their purchases. The distribution system has changed as a result of these developments as shall be seen later.

The majority of the traditional territorially based wholesale companies are subsidiaries of specific manufacturers with close financial and managerial ties to their parent companies (Nishino 1991, 86). These wholesalers not only function as distributors of the company's product but also serve as storage houses for retailers which normally do not have adequate storage space for a very large inventory (Katz 1989, A1). Unlike automobile dealers, many appliance retailers are small "mom-and-pop" shops despite the recent growth of large volume electric and electronic stores. Eighty-two percent of the total 66,000 retail appliance stores in Japan according to a 1989 survey, employ between one and four persons and a majority are keiretsu shops (Nishino 1991, 86). Matsushita Electric, for example, has in its distribution keiretsu
about 25,000 retail appliance shops, Toshiba, 12,000, and Hitachi 10,000 keiretsu outlets (ibid, 86-87). Although maintaining a large number of keiretsu outlets has become difficult and costly to parent manufacturers, they continue to keep as many retail outlets as possible in order to maintain sales volume of their products and to preserve name recognition of their products.

Formulation of Distribution Keiretsu in the Home Electric Appliance Industry

Distribution keiretsu in the home electric appliance industry dates back to the Great Depression in the 1930s. The industry in the prewar period consisted of small and medium sized appliance manufacturers. Distribution outlets were controlled by either independent wholesalers or general trading firms, which directed the "activities of captive manufacturers and small retailers alike" (Covey 1981, 52). In face of a collapsing market, caused in part by the excessive competition and discounting of prices by independent wholesalers and retailers, Matsushita, the leading company, attempted to organize wholesalers to bolster prices and to promote business stability. The framework of keiretsu was laid in these efforts even though the distribution network system like the Japanese electric and electronic industry was "still in its infancy" (Yoshino 1968, 93).
During the home electric appliance industry's first post-war consumer boom in the 1950s, Matsushita strengthened its sales network through keiretsu ties by designating wholesalers and assisting them through capital participation and by supplying managerial skills. When the economic boom was ending, Matsushita brought more retailers under the keiretsu network by paying rebates to those who agreed to buy only their products from keiretsu wholesalers. They were able to build an exclusive retail sales system by this means.

Matsushita's distribution keiretsu network became a model for other manufacturers by the end of the 1950s. But, when other manufacturers such as Hitachi and Toshiba entered the business of home electric appliances in the mid 1950s, Matsushita's keiretsu network was a major obstacle (Miyazaki 1983, 158; Tsuruoka 1980, 94-95). The success of these latecomers depended on their ability to market their products, but they had no distribution network. Their major challenge was how to distribute their products.

Toshiba eventually established an independent sales organization to act as its wholesaler. It then organized branches from this wholesale company as a retail association, called Matsuda (Miyazaki 1983, 158). Hitachi followed Toshiba's example in 1955 when it established a Hitachi Home Electric Sales Company and then organized its keiretsu retailers under the wholesaler (ibid). Other
consumer electric manufacturers followed similar arrangements during the late 1950s so that the home electric industry was "almost completely integrated into keiretsu distribution networks" at the wholesale level (Ishida 1983, 328). Wholesalers are "tied exclusively to a particular manufacturer" through capital investments, personnel transfers, and the allocation of products to them based on territories (ibid). At the retail level, shops are not as totally controlled by manufacturers. "About two-thirds of the 40,000-odd retail outlets," were "affiliated with a particular manufacturer" in the early 1960s (Yoshino 1968, 115). The percentage of retailers in keiretsu grew to 80% by 1977 (Tanba 1989, 173), but in recent years it has been increasingly difficult to hold the retail dealers in the keiretsu and the percentage has fallen to 40% by the 1990s.

Impact of the Distribution Keiretsu on the Domestic and International Economy

Home electric appliance manufacturers benefit several ways by having distribution keiretsu linkages. First, cost of distributing and storing products can be minimized by shipping products in bulk to designated wholesalers. Wholesalers, in a sense, serve as the manufacturers' warehouses. Second, manufacturers can better monitor their keiretsu dealers and protect the reputation of their products. Since keiretsu dealers basically carry only their
manufacturers' products, they are most conscious of the need to preserve its reputation. Under guidance from the manufacturer, keiretsu dealers can provide better "customer service" (Ishida 1983, 330). This close contact between the manufacturer and its keiretsu outlets also provides it with information essential in the production process. Knowing what customers want enables them to keep in step with the market. Manufacturers also can "expand their market share" by applying pressure or giving incentives to their keiretsu affiliated dealerships (Yoshino 1968, 115).

There are negative consequences stemming from home electric appliance distribution keiretsu on the domestic and international economy. First, prices of products tend to be fixed at higher levels than would occur in a purely competitive market. Cost reductions from production improvements are not necessarily passed on to consumers since the aim of keiretsu integration is to stabilize prices (Ishida 1983, 330). Prices at the retail and wholesale level are largely dictated by the manufacturers rather than by market forces. By controlling the wholesaler and retailer prices, manufacturers partially are isolated from market pressures (ibid, 331). Manufacturers can manipulate to a large degree prices of their products at the retail level through either incentives or admonitions, such as rebates or threats to stop shipping their products to dealers unless they follow the company's pricing guidelines.
Keiretsu retailers have been encouraged at times to accept excessive inventories by company programs cajoling them either with incentive programs or admonitions of sanctions. The weakness of wholesalers and retailers in the keiretsu distribution system prevents them from asserting their autonomy against the manufacturers when they are pressured to act in way contrary to the own interest and against what they perceive to be market realities.

An illustration of how the market can be manipulated by manufacturers was explicated in a FTC report of Matsushita's price fixing actions in the 1960s. Matsushita in the late 1960s engaged in price fixing arrangements, including threatening penalties of non-shipment of its goods to those dealers which did not abide with prices fixed by the manufacturer (Kimura 1984, 123-124; Miyazaki 1983, 159).

More recently in February 1993, FTC issued warnings to four major manufacturers--Matsushita, Hitachi, Toshiba, and Sony--when it found that these manufacturers individually had instructed large volume retail stores or supermarkets not to discount their products lower than their designated prices (Rafu Shimpo February 11, 1993, 11). This action by the manufacturers was designed to protect their keiretsu retailers from price competition. Despite the order by FTC, prices in their keiretsu retail outlets still are partially controlled by manufacturers.

Given the relatively few manufacturers, price fixing
arrangements are easily arranged and maintained. There are
a number of documented cases of price fixing of electronic
products by major Japanese electric manufacturers. For
example, Japan's Fair Trade Commission in 1966 discovered
that the executive officers of these firms were meeting once
a month at the Palace Hotel to fix prices. Six of the
largest color television makers which controlled 90% of the
domestic market allegedly made an agreement to set prices
according to screen size. The price was set at ten thousand
yen per inch, and commissions for retailers and wholesalers
was set at 20 and 8% respectively. They even set the range
of rebates companies could give to dealers accepting their
products. The FTC ordered them to stop and desist from this
practice (Miyazaki 1983, 159). But again in March 1992,
four companies, Matsushita, Toshiba, Sanyo, and Hitachi were
investigated by FTC for reportedly collaborating in price
rigging on their electric and electronic products sold at
their keiretsu dealers (Rafu Shimpo March 26, 1992, 13).
Manufacturers were accused of refusing to ship their goods
to dealers who did not following their pricing suggestions
(ibid). As can be seen from these cases, it is very
difficult to prevent the companies from collusive actions to
control prices.

The distribution keiretsu also make it extremely
difficult for new firms to enter the market. Extensive
outlets of the keiretsu dealers effectively block newcomers
There are few opportunities for outsiders, either domestic or foreign firms, to enter the Japanese market since there are a substantial number of wholesalers and retailers under the control of the oligopolistic manufacturers. Establishment of new retail or wholesale distribution firms is not only very expensive but also very risky since it is almost impossible to compete with extant keiretsu dealers.

Distribution keiretsu also encourages manufacturers to manipulate sales prices of products and to practice double pricing at domestic and foreign markets. This issue was raised by a Japanese consumer group in 1970 when they claimed that prices of domestic televisions were higher at home than the same models which were sold in the United States. According to a survey conducted by the National Housewives Association of Japan, doubled pricing practices for color television by manufacturers worked to the detriment of domestic consumers. Manufacturers' prices were claimed to be much higher than prices under a free market. A subsequent campaign by the association against the leading manufacturer, Matsushita Electric triggered a reduction in prices of color television which was followed throughout the industry (Kimura 1984, 131-133). Americans, since the 1960s, also have claimed that double pricing by Japanese manufacturers results in dumping of electronic appliances on the American economy. Although they have not been able to
verify the practice of dumping, the argument seriously affected bilateral relations since many American television manufactures were forced out of business as a result.

Since the same technology in the electronic field is uniformly used, manufacturers compete by making frequent minor design changes. This results in an increase in production and distribution costs. In the face of economic recession since the early 1990s, these additional costs have played a role in forcing some manufacturers to cut back or close production and distribution facilities.

Change in Distribution Keiretsu in the Home Electric Appliance Industry

Changes in the method of marketing electric and electronic appliances, along with the development of independent supermarkets, department stores and specialized high volume electronic stores in the mid 1960s, seriously challenged distribution keiretsu in the home electric appliance industry. The entry of these mass sales stores has caused a rapid decline in the number of keiretsu retail stores (Shimokawa 1985, 19). The number of retailers in the consumer electronics industry declined from 71,283 in 1982 to 65,847 in 1988. The major portion of this decline came from keiretsu stores as can be seen in Table 17. In 1977, 80% of retailers in the home electric appliance industry were keiretsu stores. Today less than 40% keiretsu shops.
In the same period mass sales stores have grown from 20 to 60% of the number of retail outlets.

Table 17. Percentage of Different Retail Stores in the Home Electric Appliance Industry: 1977-1992

<table>
<thead>
<tr>
<th></th>
<th>0</th>
<th>20</th>
<th>40</th>
<th>60</th>
<th>80</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>12</td>
<td>8</td>
<td></td>
<td></td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>18</td>
<td>11</td>
<td></td>
<td></td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>26</td>
<td>11</td>
<td></td>
<td></td>
<td>63</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>35</td>
<td>25</td>
<td></td>
<td></td>
<td>40</td>
<td></td>
</tr>
</tbody>
</table>

Legend: Large Volume Retail Electronic Stores Department Stores and Supermarkets Keiretsu Retailers

Note: The figures for 1992 are an estimate.

Source: Adapted from Tamba 1989, 173.

A majority of the keiretsu retailers are small sized "mom-and-pop" stores which have difficulty competing with supermarkets or mass sales stores. By the 1950s these keiretsu stores already were having difficulty in meeting the sales goals set by their manufacturers. In order to protect their keiretsu retailers from competition from supermarkets, manufacturers challenged these stores by refusing to ship their products to them. The strategy, however, was not successful because some wholesalers could
not resist the temptation of these large volume sales. Manufacturers then tried to protect their keiretsu retailers from competition from the high volume retail stores by setting standard prices for their products sold in the mass sales stores. The supermarkets largely ignored the manufacturers' attempts to set their prices since they could sell in large volumes and were willing to accept a smaller margin of return on each item. This inability to control prices at supermarkets forced manufacturers and their keiretsu retailers to become increasingly defensive against the penetration of large volume retail stores. Some of the manufacturers, such as Matsushita Home Electric Company stopped shipment of their products to Daiei, one of largest Japanese supermarkets, when it discounted prices of their products. Matsushita ultimately lost the battle since the courts sided with Daiei in the dispute.

Although manufacturers have attempted to preserve as many as possible of their keiretsu retailers, small keiretsu retailers are losing in the competition with these mass market stores. In order to strengthen their keiretsu dealers, manufacturers are designating core retail shops (Nonaka et al. 1990, 13) which are enlarged to enable them to be more competitive with supermarkets. Manufacturers also are supporting as many keiretsu retail stores as possible because of the ties of loyalty that still remain quite strong. The long term keiretsu ties have caused both
the manufacturers and the keiretsu dealers to take action, which could not be supported solely on rational economic grounds. Despite the growing adversities, keiretsu have maintained harmonious relations between parent manufacturers and keiretsu retail firms.

Keiretsu retailers are disadvantaged in a number of ways. They are not independent or large enough to negotiate advantageous wholesale purchases, and they are not able to discount sales prices to customers since parent manufacturers still retain power over them. Although most keiretsu retailers today handle appliances of other manufacturers, they are not totally free of the control of the parent manufacturers. Limits are still placed on keiretsu firms as to how they will operate their businesses. For example, Hitachi now permits "its 9,000 keiretsu shops" to have about 20% of "their sales from other manufacturers' products" (Sekiguchi 1990, 3). Permission to sell other manufacturers' goods was given because these keiretsu stores "cannot appeal to consumers with just one company's brand" (ibid) even though keiretsu stores traditionally have relied on parent firm's rebates to enable them to sell only the parent's products. For example, Matsushita formerly gave rebates to keiretsu firms according to the percentage of its goods sold by the retail firm. The largest rebates were given to firms which sold 90% of their sales from their products, and smaller rebates were given to stores whose
sales percentage were smaller (Hara, Takita, and Umesawa 1990, 36).

The increase of imports of electronic products from the newly industrialized countries such as Taiwan, Singapore, and South Korea by mass sales stores is also a factor weakening keiretsu retailers (Fields 1989, 57). An increase of these products into the Japanese market through "mass retailers of consumer electronics" has increased competition, impacting detrimentally on the small keiretsu retailers (Hara, Takita, and Umesawa 1990, 35; Kitada 1988; Smith 1991, 48).

Although manufacturers have tried to keep as many of their keiretsu retailers in business as possible, they are losing the battle as reflected in the decline in the number of keiretsu shops shown in Table 18.

Table 18. The Number of Retail Keiretsu Outlets

<table>
<thead>
<tr>
<th>Manufacturers</th>
<th>1980</th>
<th>1985</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Matsushita</td>
<td>30,000</td>
<td>27,000</td>
<td>24,000-25,000</td>
</tr>
<tr>
<td>Toshiba</td>
<td>14,000</td>
<td>13,000</td>
<td>11,000-12,500</td>
</tr>
<tr>
<td>Hitachi</td>
<td>10,000</td>
<td>-</td>
<td>9,000</td>
</tr>
<tr>
<td>Sanyo</td>
<td>6,000</td>
<td>-</td>
<td>5,000</td>
</tr>
<tr>
<td>Mitsubishi</td>
<td>-</td>
<td>-</td>
<td>5,000</td>
</tr>
<tr>
<td>Sharp</td>
<td>3,500</td>
<td>-</td>
<td>4,000</td>
</tr>
<tr>
<td>Sony</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
</tr>
<tr>
<td>NEC</td>
<td>-</td>
<td>-</td>
<td>2,000</td>
</tr>
<tr>
<td>JVC</td>
<td>-</td>
<td>-</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Source: Adapted from Hara, Takita, and Umesawa 1990, 36; Sekiguchi 1990, 3; Tanba 1989, 172; Tsuruoka 1980, 100.

The small keiretsu retailers increasingly find that there is no market for them. As a result, some scholars have
predicted that keiretsu retailers' market share will decline to only 25% by the year 2000 (Wakasa 1991, 42).

Conclusion

Similarly to automobile makers, manufacturers in the home electric appliance industry largely rely on production keiretsu firms for parts rather than manufacturing them in their own facilities. Production keiretsu are created with a subcontracting arrangement between manufacturers and multiple layers of companies producing parts. Unlike the automobile industry, parts for the home electric appliance industry often are standardized. As a result the ties between manufacturers and parts producers are not as close or cohesive as in the automobile industry. Subcontracting for parts in the home electric appliance industry is undertaken by much smaller firms, and many manufacturers regularly shuffle members of their cooperative suppliers associations. Furthermore, because of the diffusion of industrial technology and standardization of parts, the manufacturers in the home electric appliance industry are more vulnerable to competition and to outside pressure than the automobile industry.

Distribution keiretsu in the home electric appliance industry also are structurally similar to those of the automobile industry. However, changes in the distribution keiretsu in the home electric appliance industry have been
more substantial than that of the automobile industry. Unlike automobile dealers, many home appliance stores are still small "mom-and-pop" stores. The economic viability of these keiretsu retail stores has been challenged by the rapid growth of independent large-volume retail stores. Manufacturers have lost much of their control over pricing by retailers because of the rise of supermarkets, which have lessened the advantages they gain from controlling a keiretsu network of retail stores. The long-term fate of distribution keiretsu in the home electric appliance industry is doubtful.
CHAPTER VI

POLITICAL CONTEXT OF VERTICAL KEIRETSU

Japan's economic success since World War II has caused many to examine how the government interacts with the business sector in making industrial policies. Unfortunately, no consensus exists as to how public policies are made or how various interests influence the making of policy. At least four major concepts or models have been proposed for explaining how public policies are made and how businesses are involved in the governmental process. None of these, however, considers industrial groups or keiretsu as actors in the political process. This chapter looks at how governmental policy has affected the development and growth of keiretsu. It also examines whether vertical and horizontal keiretsu are a factor in shaping industrial policy and if so, how they influence policy.

Role of Government in the Economy

Following the postwar occupation by the United States, western liberal economic theory became widely prevalent in Japan, and many argued for free markets with little or no involvement of government in the economy. Although some economists still enunciate this idealized view of the free market, it has never existed in Japan, if it ever existed.
anywhere. According to those who espouse a strong government role in the economy, such as those advocating the Japan Incorporated model or the competing pluralist view, the neoclassical yearnings for laissez faire policies are irrelevant in the real world of modern Japan.

The second policy making model, Japan Inc. model, stresses government-led or controlled economic policies, which are supported by cooperative business sectors. The degree of government involvement in the economy varies among these observers, although all believe government is a cooperative partner in economic matters. For example, Johnson (1982) stresses a bureaucratically directed economic development. Since Japan was a late comer in the process of industrialization, a "developmental state" as he called it, the bureaucracy needed to provide leadership in economic development. The first priority of the Japanese state and bureaucracy was to foster economic development. The high priority of economic development policy came not necessarily from cultural traditions but from the bureaucratic assessment of the needs of a developmental state with few natural resource and an increasing population. The bureaucracy was to lead the development of the economy.

Another version of the Japan Inc. model states that industrial policies are not the product of the bureaucracy alone but of a triad of power consisting of the bureaucracy, the Liberal Democratic Party and large industrial firms.
There is a close cooperation between the private and public sectors in policy making according to such scholars as Abegglen (1970), Kaplan (1972), and Okimoto (1989, 145). Industrial policies are the outcome of a negotiating process (Okimoto 1989, 145) in which the public and private sectors have prior consultations before any policies are enacted. According to this view, there is extensive government intervention into the economy by government’s central planning and "administrative guidance" of private sectors (ibid). Government is to play a decisive role in the industrial policies made by the "ruling triad."

A third view of the policy process is the pluralist model. Pluralists believe that competition exists among all "social interest groups" in the nation in the policy process (Sato and Matsuzaki 1984, 66-100). They dispute the idea that there is a homogeneous interest in the bureaucracy, the private sector, or in the ruling political party. Numerous instances of disparity or conflict of interests between the bureaucracy and business sector, and between the bureaucracy and the ruling Liberal Democratic Party, are pointed out by such scholars as Curtis (1983), Otake (1980), Patrick and Rosovsky (1976, 48), and Richardson and Planagon (1984). It is argued that neither the Liberal Democratic Party nor the bureaucracy are monolithic since various factions within them vie for power (Patrick and Rosovsky 1976, 48-49), and
the same is true in industry.

Other pluralists reject the concept that all social interests are able to compete in the policy process but instead suggest that there are powerful and dominant groups in industry, the bureaucracy, and the party which allies under the leadership of bureaucracy. According to this view of "patterned pluralism," the bureaucracy is seen as most powerful in making industrial policy. Industrial policy is believed to be the result of fixed patterns of political alliance between political parties, interest groups, and the powerful bureaucracy (Muramatsu and Krauss 1987, 537-538). Still others add the idea of "administered pluralism" to the concept of patterned pluralism (ibid, 537) where the bureaucracy provides only a coordination role, not a dominant role in setting industrial policy. Both patterned and administered pluralism, however, suggest a relatively fixed pattern of political alliances among actors under the guidance of the bureaucracy. While "patterned pluralism" suggests that bureaucracy is the dominant leader among the various actors, administered pluralism suggests that bureaucracy acts only as a coordinator to carry out policies made by all of the dominant actors.

Others such as Calder (1988) reject both the Japan Inc. and the pluralist models of industrial policies and assert that industrial policies are made in reaction to circumstances on an ad hoc basis. The Japan Inc. view which
stresses harmonious relations between the private sector and government is criticized as being unrealistic (Calder 1988, 8). Furthermore, the role of the bureaucracy in both patterned and administered models of pluralism are attacked as being unable to deal with non-routinized policies (ibid, 11). The bureaucracy may serve as a leader or coordinator over routinized industrial policies, but it cannot dominate the making and administration of non-routinized policies. Instead, Calder (1988) finds that Japanese industrial policies are made in reaction to cyclical pressures. They are purely pragmatic and are made on an ad hoc basis. Public policy making, Calder suggests, is a reaction and accommodation to crisis coming out of "economic and political turbulence" (ibid).

A major weakness of all these models or how the government is involved in the economy is that they do not consider how groups such as keiretsu influence industrial policy. As a result of this oversight, the models fail to consider the fundamental makeup of the economy. The way states participate in the economy varies according to the nature of the economy and the way markets are arranged (Okimoto 1989, 16). To overlook keiretsu in Japan results in a serious flaw in these theories and consequently, policy making.

When industry is directed by fewer firms or is more unified, government can more easily become involved in its
direction. A characteristic of vertical keiretsu structures, for example, enables government to more easily intervene in the market since such grouping under a parent firm centralizes control over the industry. Both the degree of centralization of government and the business sector affects the degree of how much government may become involved in the economy.

The subsidiary or subcontracting tie of the vertical keiretsu with dominant parent firms gives the parent firms much influence over subordinate firms and makes intervention by government in the economy easier. Government can gain consensus about industrial policies by negotiating with the relatively few core companies in various industries. Generally, involvement by government in highly diversified industrial sectors such as general trading firms is more difficult than in more unified sectors (ibid, 139). But even in the highly diversified industrial sectors in Japan, involvement by government is relatively easy since they too are vertically organized into tree-like keiretsu. Existence of keiretsu networks enables government to transmit and receive information on proposed industrial policy by dealing only with a relatively few parent firms (ibid, 140). Government can use various members from the top firms to organize team projects for considering future economic endeavors in a specific field.

Some governmental policies, however, are made more
difficult to enact and implement because of keiretsu, such as mergers of the parent firms to rationalize and strengthen industrial sectors. For instance, the government's proposed policy to unify or merge the eleven or so manufacturers into two or three dominant firms in the 1960s failed because of resistance from rival keiretsu. Competition among rival keiretsu in the industry led to the mobilization of all the keiretsu firms in the industry against any governmental policy which threatened the status quo and their position in the industry.

All four conceptual models of policy making fail to consider how keiretsu affect the economy and how they influence public policy. Next the political context of vertical keiretsu is examined.

Keiretsu in the Political Context:
Government and Keiretsu Relations

Development and growth of keiretsu after World War II were stimulated by favorable governmental policies which encouraged the formation of keiretsu groups to increase production and to improve the country's international competitiveness. The pro-production emphasis of Japan's policy encouraged the private sector to consolidate and develop corporate groupings, either as zaibatsu in the pre-war period or as keiretsu in the postwar period. These industrial groups depended more on a favorable political
climate than on economic forces or cultural traditions.

Japan's industrial policies supporting development and growth of keiretsu reflect the nature of the public policy process and reveals the pro-production proclivity of government. In industrial areas which are less diversified, public policies, as can be seen during the infancy of the automobile and electronic industries, are made in a fashion similar to that suggested by Johnson. National planning to improve Japan's international competitiveness in these industries was a promotional activity proposed by the bureaucracy in conjunction with leading segments of industry. During the early years of these industries, there was little political conflict over this policy.

In industrial areas such as agriculture and small businesses which are highly politicized, policies are political compromises made on an ad hoc basis, as Calder (1988) suggests. Government responds to political pressures from agriculture and small business constituencies since these groups are politically strong. Farmer organizations, such as the All Nippon Farmers Association, or "zenno" as it is called, are politically consolidated and have a strong lobby which gives them access to major political parties and key governmental institutions. Similarly, small business firms, because of the size of this constituency in the Japanese economy, have the power to get its demands met. Policies in these politicized situations are enacted on an
ad hoc basis to meet specific demands from these groups.

In the infant stage of development of industry, such as the high tech industries, government policy may have been more innovative and future oriented, as Johnson's Japan Inc model suggests. Future oriented industrial policies in the promising industries, such as the automobile and home electric appliance industries encouraged consolidation of industries and development of keiretsu ties among firms. To encourage industrialization in these targeted areas, the government provided such incentives as government funding, subsidies, and access to valuable foreign patents and technology (Majumdar 1988). Such policies in the pre-World War II era encouraged Japanese firms to form corporate groupings around zaibatsu families. The government also encouraged existing small firms to connect as subsidiaries or subcontractors with larger key industries under the slogan or motto of "fukoku kyohei," which means promotion of a rich nation and a strong army.

In the postwar period, government policies contributed to the promotion and consolidation of banks, general trading and large manufacturing firms into horizontal and vertical keiretsu. The government promoted corporate groupings through its pro-production policies of encouraging small infant firms to develop ties with strategic industries rather than to compete and perhaps disappear as a result of competition with larger firms. These policies helped set
the unique foundation of Japan's industrial structure, where there is a superimposition of the modern sector of a few large firms over the numerous firms of the traditional sector. This unique arrangement in the industrial structure was necessary because of the country's capital shortage and need for modern technology. It enabled Japanese firms to use these scarce resources in a concentrated way under the control of large firms, the zaibatsu in prewar period, and the keiretsu since World War II.

Despite the apparent ease of enacting future oriented industrial policies by government, the making of such industrial policies was not free from politics and disharmony. The case of the automobile industry illustrates the conflicting bureaucratic politics over such policy. The government's central bank, the Bank of Japan, which is under the jurisdiction of the Ministry of Finance (MOF) opposed in the immediate post World War II era the plan by the Ministry of International Trade and Industry (MITI) for helping develop an automobile industry. The Bank of Japan contended that government should not get involved since it did not have adequate technology to be competitive internationally and it was too costly and risky to undertake such a policy. MITI's plan, however, ultimately was adopted through a process of bureaucratic politics when it overcame the Bank of Japan's objections.

Once the industrial structure in high tech industries
was established after World War II and keiretsu networks developed, government and business relations no longer were as harmonious and often were antagonistic. Government underestimated the development of a sense of independence or autonomy among firms in keiretsu networks. For instance, MITI's plan in the 1960s of reorganizing and merging automobile manufacturers into groups for producing regular passenger, mini, and specialty cars was met by a barrage of political opposition from the automobile manufacturers and their keiretsu firms (Rugman and Verbeke 1990, 78). It clearly was evident from this political skirmish that keiretsu had become political actors which would fight for their perceived interests. Again in the 1980s when the government attempted to require the automobile industry to restrict its foreign exports of cars to the United States, the automobile keiretsu mobilized and again resisted governmental polices which adversely affected them. As a result of the politicization of keiretsu, government has had a more difficult time in persuading the competitive industrial sectors, such as automobile and home electric appliance industries, to adopt voluntary export constraints. MITI and other governmental ministries, therefore, often have to rely on threats of foreign pressure to induce industry to comply with policies limiting exports or requiring the purchase or sale of more foreign goods (Destler 1992, 52).
In this increasingly politicized environment, the government's industrial policies are mainly made on an ad hoc basis and aimed at resolving economic conflicts and dealing with international pressures rather than planning and promoting future development. The bureaucracy as a result of the defensive political actions of keiretsu no longer can play the type of leadership role it used during the infancy of these industries. Its role has become much more politicized, requiring negotiations and compromise among various interests, including keiretsu.

The nature of industrial policy in Japan also reflects the economic and cultural norms of the society. Japanese government traditionally has been involved economy in order to compensate for the structural and institutional deficiencies in the labor and capital market (Okimoto 1989, 17). The government has had a long history of participating in the economy and has never let the free market take its "natural course" (ibid). In part, this is because the Japanese labor and capital markets are different from those in the United States and Great Britain.

The labor market in Japan rests upon the concepts of life-long employment with little mobility of labor, especially among larger firms (ibid, 16). Employees are expected to stay with one company and in turn to be loyal to that company (Ouchi 1981, 28-29). Furthermore, labor unions are basically company unions, not industry wide unions.
This arrangement for unions complements the employment practice, but it weakens workers' political power since they are not mobilized on a nationwide basis as in the United States and Great Britain. Thus, the characteristics of the labor market results in a governmental orientation which is more pro-business and anti-consumer in character than industrial policies in the West.

Capital markets in Japan, especially after World War II, were not as fully developed as those in the United States and Great Britain (Okimoto 1989, 17). The shortage of capital in the nation caused companies to rely on banks or firms with keiretsu ties rather than on selling bond or stocks in the open market. The lack of sources of new capital investments forced companies to rely on loans from keiretsu banks or other firms. The high ratio of debt finance of companies, coupled with the commitment to life long employment makes Japanese industry very vulnerable to down turns in the economic cycle (ibid, 37). As a result, governmental policies have been supportive of the keiretsu networks with close links between banks and member firms as a means of offsetting potential vulnerability during economic downturns. Furthermore, the differences in both the labor and capital markets have caused government to be more cooperative and supportive of industry and not to adhere as strictly to anti-monopoly laws so common in the West. As a result, although Japanese anti-monopoly laws
Monopolies in Japan were not considered a problem in the prewar period because of the pro-production stance of government. Government traditionally promoted cartels as a means of avoiding bankruptcies of industrial firms during economic recessions and periods of high unemployment. Furthermore, the military's need for industrialization led to governmental approval of 1,500 cartels in the 1930s and 1940s (McCrow and O'Brien 1986, 84). Zaibatsu especially became the major form of industrial organizations used to supply and equip the military before and during World War II. The government's sponsorship of cartelization of industries resulted in the combination of diverse groups of companies under control of zaibatsu families such as financial institutions, including large commercial banks and insurance firms, and heavy industries such as steels and chemicals, as well as large trading firms. Although a member company of each zaibatsu alone did not have a monopoly over the market by itself, as a group, zaibatsu's control of finance, manufacturing, and trading gave it oligopolistic powers.

After World War II, the occupation government sought to
dismantle zaibatsu since they were seen as the major supporters of the imperialistic government. These efforts to remake the economic system, however, were diverted by the rise of political tensions between the United States and the Soviet Union as the Cold War began. It was believed that further weakening of the Japanese economy by dissolving zaibatsu would create greater economic and political instability in the region. As a result, the actual dissolution of these oligopolistic organizations was more limited than originally planned. Only eleven zaibatsu companies out of 325 originally designated for dissolution in 1946 were completely dissolved by 1948 (Yoshino 1968, 123). Although the policy of dissolving these zaibatsu monopolies was not fully carried out, progress was made in removing ownership from the four main zaibatsu families. The Holding Company Liquidation Commission under the occupation government forced the owners of stocks in these zaibatsu firms to exchange stock for government bonds. Later these bonds fell in value, stripping the zaibatsu families of much of their wealth. The stocks collected from the zaibatsu families eventually were sold to employees of the firms and the general public. After the occupation ended in 1952, horizontal and vertical keiretsu began to be created as aggregations of independent manufacturing firms coalesced around major commercial banks and general trading companies. The new organizational ties replaced the
zaibatsu families.

Although the new industrial groupings or keiretsu have power and potential of controlling the market and of undertaking other collusive activities, economic ministries such as MITI and MOF have not challenged them or enforced the anti-monopoly provisions vigorously against these business groups. Government still tends to depend on monopolies and cartels as a means of resisting the ills of recession. The limiting of enforcement of the anti-monopoly laws against oligopolistic industries has strengthened keiretsu. It is one of the major reasons why keiretsu have grown to be as influential as they are in the modern economy.

Enforcement of anti-monopoly laws focuses mainly on market concentration of a firm which affects prices and not on the problem of intercorporate connections (Okumura 1985). Unlike anti-monopoly laws in the United States, in Japan there are few provisions prohibiting intercorporate groupings as in horizontal or vertical keiretsu. Companies are not restricted from holding stocks in other firms as in the United States (ibid, 231). This difference in anti-monopoly laws results in the partial mergers of firms in keiretsu. In the United States, on the other hand, large firms tend to integrate companies by merging rather than grouping interdependent firms (ibid, 233).

Japan's more permissive business climate and weaker
enforcement of anti-monopoly laws is due in large part to the fact that anti-monopoly laws were imposed by occupation forces after World War II, and they have never had the public acceptance or support they do in America. Monopolies and cartels in the United States are seen by the public as an "anathema to the countries' economic well-being and system of democracy" (Okimoto 1989, 38). Support for anti-monopoly laws among the general public is high, especially at those times when populist views dominate politics as is reflected in the series of anti-trust laws enacted during the late 19th and early 20th century. The Japanese people and government, on the other hand, believe that selective cartels are necessary to promote industrialization and to preserve economic stability in the country. There is no history of periodical outcries for controlling the nation's corporate giants as in the United States.

Lack of public support for the anti-monopoly laws also made them vulnerable to amendments. Even before the occupation ended, the original anti-monopoly law of 1947 was amended to permit non-financial firms to hold stock in other firms so long as competition was not constrained (Okumura 1985, 228-229). Again in 1953 another amendment further weakened the prohibition on stock holdings in other companies so that virtually any nonfinancial firm may hold stock in any other firm (ibid, 229). These amendments to anti-monopoly laws enabled keiretsu relationships to spread
Lax enforcement of the anti-monopoly laws by the bureaucracy also encouraged development of cartels. MITI, for example, worked with the Fair Trade Commission (FTC) to exempt major industrial firms from provisions of the Anti-monopoly Law in 1966 so that a few large firms through reorganization could dominate industry to become internationally competitive. The pro-big business bias and the lax enforcement of anti-monopoly laws resulted in the growth of cartels. By the late 1960s, 20% of manufacturing was covered by legally approved cartels (Caves and Uekusa 1976, 154).

MITI in the late 1950s even tried to get the anti-monopoly laws repealed and replaced with statutes which would promote the international competitiveness of Japanese industries. The attempt failed partly because the economic boom of the 1960s caused a loss of interest in the legislation (Johnson 1982, 226). MITI, nevertheless, was successful in enacting a series of exemptions against the anti-monopoly law which promoted the development of cartels generally. For instance, specific exemptions of the anti-monopoly law were enacted for the textile, the machinery, and the electronics industries. In this pro-cartel climate, the number of legalized cartels grew from 162 in 1955 to about 1,000 by the early 1970s (Okimoto 1989, 7).

Following the Arab oil crises of the 1970s, however, a
severe inflationary period caused a public outcry against firms accused of collusive acts for keeping prices artificially high. Consumers reacted strongly and claimed that goods were being kept out of the market intentionally by manufacturers and their keiretsu distributors. Government responded by strengthening enforcement of the anti-monopoly laws and by amending the laws and placing limits on the amount of stock non-financial firms could hold in another company. The amended law applied, however, only to firms within a limited capitalization bracket, and even on those firms there was a 10 year moratorium before it was to become effective (Okumura 1985, 230). The pro-business bias of the Japanese government is evident even in periods of public demands for consumer protection.

Responsibility for enforcement of industrial laws, including the anti-monopoly provisions, are fragmented in Japan. Although the Fair Trade Commission (FTC) is officially responsible for enforcing anti-monopoly laws, in practice the power and responsibility over this function is divided among all of the industrial ministries, such as MITI, MOF, and the Ministry of Economic Planning (MEP). FTC as an independent law enforcement agency is quite small in terms of the number of staff members in comparison to its American counterpart, the antitrust divisions of the Federal Trade Commission and the United State Department of Justice. It does not have nearly the prestige and power of the
American agencies. Its chief executive officer customarily is an ex-career bureaucrat from MOF who is expected to know the informal "rules of the game" in coordinating activities since enforcement of monopoly law by FTC requires coordination with other ministries and business interest groups (Imogawa et al. 1992, 27-28; Kikuchi 1990, 55; Shukan Daiyamondo 1990, 26).

The major problem in Japan of enforcing anti-monopoly laws and getting coordination from ministries involved is that FTC has almost no constituency supporting vigorous enforcement of anti-monopoly laws. Some industrial ministries, such as MITI and MOF, as well as leaders of the Liberal Democratic Party, the nation's ruling party, hold the opinion that anti-monopoly laws should not interfere in industry's pursuit of becoming internationally competitive.

As a result of this political climate, MITI sought to have the anti-monopoly laws abolished in the 1960s. After failing in its efforts to repeal the legislation, MITI sent a directive to FTC directing it to consider the effects on international competitiveness of Japanese firms in all anti-monopoly proceedings. FTC was persuaded by MITI to make only very pragmatic and lenient application of anti-monopoly laws against major industries. MITI's pressures on FTC to be lenient and pragmatic led to even more mergers of cartels. The result was that the number of mergers continued to increase.
The merger of the two largest steel firms of Japan, Yahata and Fuji Iron and Steel companies to create the Nippon Steel Company was symbolic that MITI had won the dispute with FTC. This merger broke the administrative rules against mergers of companies holding over 30% of the market of a product (Bieda 1970, 223-224), and thus opened the way for mergers of larger monopolies. Administrative guidance by MITI in the anti-monopoly field continued to promote exemptions from the Antitrust law as well as to violate principles of the free market. Exemptions and amendments to the Anti-monopoly Law in the 1950s and 1960s enabled horizontal and vertical keiretsu to continue to expand in number and influence.

Changes in Government Policies: From Overcoming Systemic Deficiencies through Promotional Incentives to Preserving Orderly Development

As Japan’s post war economy developed, the purpose of industrial policies shifted from an emphasis on overcoming institutional and systemic deficiencies in the economy to preserving orderly development of industry. Throughout the 1950s and 1960s emphasis of governmental policies were to harness and guide the economy in order to achieve industrialization. Much of the effort in that period was aimed at building the infrastructure of industry so as to overcome the poor international competitiveness due to the
lack of capital and technology. Efforts of the bureaucracy in this period were to guide the economy into those industries in which Japan had a chance of competing internationally. Government policies in the earliest years focused on building chemical and heavy industries (Johnson 1982, 31; Okimoto 1989, 25). Eighty three percent of the loans of the Japan Development Bank in this period went to MITI’s designated strategic industries which included shipping, steel, coal, and power utilities in order to build the essential infrastructure for Japanese industry (Johnson 1982, 211).

Various types of aid also were given to the small business sector so as to help develop and modernize production equipment and facilities related to designated strategic industries. Aid was usually in the form of low rates on loans via public financial institutions, development of training seminars for managers by MITI and local governments, authorization for cooperative activities among firms to avoid the anti-monopoly provisions in the creation of keiretsu and tax concessions (Caves and Uekusa 1976, 152-153). Aid in the form of administrative guidance also assisted enterprises to increase intercorporate stockholding in order to protect firms from foreign takeovers (Okumura 1985, 89). This defensive scheme for preventing foreign capital from taking over Japanese industry was in reaction to foreign pressures for Japan to
open its capital markets to the world. By encouraging mutual stock sharing of companies by its major banks and leading domestic trading companies (ibid, 82), government hoped to create obstacles which would prevent foreign takeovers of Japanese firms. This practice also facilitated and strengthened corporate groupings of keiretsu.

Governmental industrial policies in reaction to international pressures were not always necessarily coherent and often were short-sighted and reactive to pressures to liberalize trade and capital. A sense of vulnerability of Japanese industry permeated the bureaucracy, particularly MITI. Contrary to the crises and vulnerability mentality held by government, exports of Japanese products more than doubled in the period from 1960 to 1965 from $4 billion to $8.7 billion (Johnson 1982, 252). The bureaucracy also feared that if foreign capital got even a toe-hold in Japanese business, they would lose their ability to influence the direction of the economy. They believed that their use of administrative guidance of industry, which rested not so much in the law but rather on informal acceptance, would be lost if foreigners came into Japanese business (Bieda 1970, 225).

By joining the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), as well as becoming a party to the General Agreement of Tariff and Trade (GATT) in the 1960s, Japan obliged
itself to open its trade and capital markets. In order to cope with these new international pressures, MITI responded by establishing the Industrial Structure Investigation Council (Sangyo Kozo Chosa Kai), as an advisory organization of business leaders and bureaucrats to study the ratio of industrial concentration, exports, and capitalization in comparison with those of Western states (Johnson 1982, 253). This council concluded that Japanese firms were potentially competitive but were not strong enough to vie with Western counterparts (ibid). To cope with the pressure of liberalization of trade and capital, as well as with the "giant foreign producers," MITI encouraged additional mergers of smaller firms with a few large companies (Okimoto 1989, 25). Again government authorized owning shares of group firms and rival companies to help defend the group firms from being taken over by foreigners.

Government's concern that there was too much competition among keiretsu manufacturers and that an overcapacity of production existed as a result led to proposals to further rationalize industry so as to control competition and lessen excessive production capacity. These proposals, however, underestimated the political and economic power of firms in the keiretsu. Government's efforts to consolidate and rationalize key segments of industry into a few large firms through mergers, as it did in the automobile industry, had little success due to
resistance of keiretsu firms. Government met strong resistance from smaller keiretsu manufacturers to the attempts at merging them with larger producers not in the same family of keiretsu. The government's action to rationalize these industries were seen as an infringement on the autonomy of business to belong to their own keiretsu. The growing economic and political power of keiretsu ultimately forced the bureaucracy to abandon these plans for further consolidating industry.

Because of the rise of new internal and external pressures in the economy, governmental industrial policies since the mid 1970s have changed from the promotional role they had played since World War II to more of a political role of arbitrating and resolving conflicts in order to preserve orderly development. The traditional emphasis of compensating for institutional deficiencies and shaping the structure of industry changed to a policy of containing domestic and foreign conflicts. This change occurred in response to both domestic and foreign economic and political pressures. Government's pro-production stance increasingly was challenged domestically by growing demands of consumers for protection from ills of rapid industrialization and from industrial pollution which became a major public issue as industrialization occurred.

The increasing pressures from the international community to redress the trade imbalance situation between
Japan and its trading partners also forced MITI to change the orientation of its policies and to seek to accommodate foreign pressures for importation of more industrial goods. Although Japan along with other industrialized trading partners has lowered formal trade barriers such as tariffs and quotas for imported goods and compiled with the norm of international agreements i.e., the agreements made in the multinational trade negotiations of GATT, Japan's surplus in the balance of trade and its low ratio of imports of industrial goods continues to be a sore point in international relations. Foreign governments since the 1970s increasingly have felt threatened by the flood of Japanese products being imported into their markets which often increased domestic unemployment. Protests and demands that Japan reciprocate by opening its market to foreign goods forced the Japanese government to reach political agreements to voluntarily limit its exports and to promote the sale of more foreign goods in Japan. As a result of these international agreements, MITI's role increasingly became more of a mediator in the trade conflicts between Japan and foreign trading partners.

MITI's position as an internationalist since 1970s and its role in accommodating interests of Japanese consumers has in fact caused it to clash with other more conservative industrial ministries such as MOF and the affected industries. MITI now recognizes international
competitiveness of major Japanese firms and the need of importing industrial products of foreign countries in order to more nearly reach a trade balance. Government policies, especially MITI’s, thus have shifted from solely promoting major Japanese industries and the protecting of weak economic sectors to a more flexible enforcement of policy in keeping with international pressures. While MITI now emphasizes orderly exports and an opening of Japanese markets, like other domestic ministries it still continues to resist trade liberalization in the agricultural sector.

Despite these modifications in industrial policies, there is still a pervasive fear of a foreign takeover or subordination of Japan’s economy and an uneasiness about economic insecurity. There also remains a sense of urgency for catching up or surpassing other producers, especially in high technology such as IBM in computers and AT&T in communications. These spectral apprehensions in the Japanese psyche, which are rooted in post war experiences, still influence the bureaucracy and Japanese politics generally. As a result, the more internationalist position of MITI does not necessarily mean that the Japanese government is moving toward a totally free market or that it has abandoned the competition to catch up with the West or its compulsion for ensuring against economic insecurity (Okimoto 1989, 28). Changes to meet the demands of its foreign trading partners, such as further opening up Japan’s
market, still are made only grudgingly since they not only rekindle the nation's psychic fears, but also threaten structural conditions of industrial firms. Foreigners' demands for strengthening anti-monopoly laws in Japan are particularly threatening since they challenge the very foundation of the business structure, keiretsu. New governmental policies, therefore, remain largely ineffective in expanding imports of foreign products since the keiretsu structure has developed and increased its political power.
The structure of the Japanese political economy was shaped by cooperative relations between government and business in the early years after World War II. In this infancy both the automobile and home electric industries were assisted by government. The pro-business emphasis of government buffered these emerging industries from threats of both the internal and external environments. The domestic anti-monopoly laws were manipulated to benefit these industries, and governmental strategies protected them from foreign takeovers. As a result of the cooperative relations between government and business, MITI guided and directed them on to a path to international competitiveness. As these industries, along with their keiretsu grew stronger, the political economy changed. Government’s role in the economy changed. This transformation is discussed in this chapter.

Policy Changes and Vertical Keiretsu in the Automobile Industry

There was a growing consensus that the government should protect the market from foreign imports in the
automobile industry of the early 1950s. Since the automobile industry before the 1950s was very small and fragmented, as was the case with the home electric appliance industry, it had not received a high priority in the government's economic plans. It, therefore, took a "back seat to other industries" such as the steel industry which was a main priority of government (Kaplan 1972, 43). Government had helped in building the indigenous automobile industry in the prewar period in order to supply essential military vehicles, especially trucks. After the war, however, the industry was left to the initiative of the private sector (ibid, 53). Toyota and Prince Motor Companies, for example, were compelled to develop their own technology without much involvement from government (ibid, 54). Other car manufacturers entered into licensing arrangements for technology with foreign automobile companies. Most of these arrangements were made without governmental assistance since MITI's role was limited to the approval of the licensing agreements (ibid). The government assisted this infant industry in the early postwar years, mainly by increasing tariffs on imported cars into the country.

MITI turned its attention to the growth of the industry in the 1950s after entrepreneurs showed interest in the field (ibid). It began to argue for governmental support for the development of an indigenous motor vehicle industry.
and called for tariffs to restrict the importation of foreign cars. The various industrial ministries, however, did not agree. The Ministry of Transportation, for example, opposed MITI's proposal for a "temporary restriction" on imported cars (ibid, 52) since it did not believe that the government should help in the development of domestic automobile industry. The Bank of Japan also opposed MITI's proposal for allocating funds to the emerging industry in view of "scarcity of capital and the size of the reconstruction tasks" (ibid). Resolution of the debate between the ministries was influenced by the large increase in demand for motor vehicles during the Korean War. The Bank of Japan changed its position on the issue and as a result of the sudden economic boom agreed with MITI.

As a result of the new consensus, the domestic market for automobiles was protected through tariffs and quotas on imports until the industry could attain international competitiveness. Furthermore, to prevent a possible takeover by foreign capital, a defensive strategy was forged by creating intercorporate keiretsu holdings. Also, it was agreed that auto parts manufacturers would be strengthened through governmental programs. The 1956 Machinery Industry Act strengthened auto parts manufacturers by making governmental loans to the first and second-tier auto parts suppliers.

Pressures from the international community that Japan
open and liberalize its markets increased in the 1960s after Japan joined the International Monetary Fund (IMF), General Agreement on Tariffs and Trade (GATT), and Organization for Economic Cooperation and Development (OECD). These international treaties agreed that no nation would set trade barriers because of a trade imbalance. Before joining these international organizations, Japan was free to set import restrictions and tariffs to protect its emerging industries. However, after signing these treaties, it could no longer use tariffs to restrict imports to redress trade imbalances. Under these treaties, however, they could use some "quantitative controls" such as quotas to prevent excessive imports. Japan, therefore, decided to delay liberalization as long as possible and then to use the quantitative control exemptions to protect the economy. With this strategy, imports of "engines, engine parts, chassis for engines, and used cars" were not liberalized until 1970 (Genther 1990, 130).

Government relations with the private sector changed from cooperative to conflictive after the industry began to develop. Bureaucratic initiatives came to be seen as interference and attempts to control business. MITI's late 1950s proposal to have one company producing a prototype passenger car to compete internationally was met with opposition from the major manufacturers, including Toyota, Nissan, Isuzu, Prince, and Hino Motors. Some smaller
manufacturers of motorcycles and three-wheel cars showed interest in the project, however, since they hoped to become the selected maker of specialized vehicles. Objections were also raised over the proposal that MITI would target the pricing of cars, and that these governmentally set prices would be too low (ibid, 103). Opposition also came from firms in the keiretsu subcontracting system (ibid, 115) which felt threatened by the proposal to reduce the number of car manufacturers.

Later in the mid 1960s, MITI proposed to create an industrial pattern similar to the American Big Three, merging Isuzu, Mitsubishi, and Fuji Heavy Industries, to form a third competitive automobile maker. It was believed that this industrial pattern would allow Japanese firms to be more competitive internationally. This proposal also failed because of the intense political opposition it generated among all the key actors in the industry.

After this political defeat to create a Big Three System similar to the American pattern, MITI suggested still another plan to organize the industry into three groups of specialized motor vehicle producers: conventional passenger cars, mini cars, and specialty cars to include sport cars and trucks or vans. MITI also believed that such specialization would be most productive if only two companies produced passenger cars, two or three would manufacture mini cars, and another two or three would
specialize in the specialty cars (Genther 1990, 135; Kaplan 1972, 122). Under this plan, the smaller automobile makers would either merge with larger firms or be eliminated within several years. This proposal met with intense political opposition. Although Toyota and Nissan stood to benefit the most from the plan, they remained neutral since they were concerned about the increased involvement of government in their business (Genther 1990, 140). Other manufacturers such as Toyo Kogyo (Mazda), Daihatsu, Mitsubishi, and Fuji rejected the plan since by 1962 they all were manufacturing both mini and conventional passenger cars. They viewed this proposal as being aimed solely at eliminating them and their keiretsu firms. Again, political opposition overcame MITI's proposal.

With full development of the basic structure of the automobile industry, subsequent changes in the industry were shaped by business transactions rather than governmental actions. For example, the first and only formal merger of a major automobile producer occurred between Nissan and Prince in 1966 as a result of an initiative of Prince (Kaplan 1972, 124) and its major bank, Sumitomo, after Prince ran into financial difficulties. The merger of the two automobile companies was seen to be advantageous to both, and it was only indirectly encouraged by the government.

Other joint ventures occurred in the 1960s due either to financial troubles of one or the other of the partners or
because of perceived advantages to both. The "business merger" between Toyota and Hino in 1966, for example, occurred as a result of the financial troubles of Hino (Genther 1990, 149). Hino's strength in the manufacturing of trucks at the same time was perceived as complementing the strength of Toyota which produced passenger cars. A similar joint venture was created between Toyota and Daihatsu in 1967. Toyota, which was successful in the production of passenger cars, joined in a venture with Daihatsu which was successful in producing mini cars because of the perceived advantages of working together. None of these examples of joint ventures by business had government as the initiator or major actor.

MITI by 1975 had to accept the reality that it no longer could direct reorganization of the automobile industry. The recognition of the new reality reflected in part the fact that the industry had grown to be truly competitive internationally. The tripling of the Japanese share of the United States automobile market and the increase of exports from 1.26 million cars in 1970 to 2.32 million in 1979 was proof positive. Furthermore, the increasing ties between smaller Japanese car manufacturers and foreign automobile firms symbolized the decline of MITI's powers over the industry. The announcement by Mitsubishi motor company in 1971 of its affiliation with Chrysler motors shocked MITI and affirmed the beginning of
an internationalization of the automobile industry. Japanese automobile firms no longer listened first to MITI about their operations.

As a result of the new reality in the automobile industry, MITI could no longer enforce a policy of total exclusion of foreign investments in Japanese firms. Its policy changed from total exclusion of capital to one minimizing foreign capital ownership. MITI now sought to limit foreign involvement in joint ventures to less than one-third ownership since under Japanese Commercial Law any stockholder with less than one third of the total stock had no veto or control (ibid, 167) over the policies or management of a firm. Smaller automobile makers under this proposed guidance of MITI could maintain their independence from foreign investors so long as they limited foreign capital to less than one third of the total. Mazda, for example, followed MITI's guidance when it sold to Ford 24.7% of Mazda capital in 1979. Capital affiliation between Mitsubishi and Chrysler and the affiliation between General Motors and Isuzu, however, exceeded the guidelines proposed by MITI. Chrysler obtained 35% of the shares of Mitsubishi and GM received 34.2% of Isuzu. Despite this fact, they believed that they could maintain control over management by controlling a majority of the stock. Such decisions were made with little or no advice by MITI.

The increasing affluence of Japanese automobile makers
also diminished MITI's influence due to the allocation of governmental grants and financial assistance. Keiretsu firms with their major banks had become more independent as a result of their new affluence. The small amount in grants from the government, which were so appealing in the early years of the 1950s, no longer were an inducement to follow MITI's lead. By the 1970s, government played only an indirect role in preserving economic viability of companies. Bankruptcies of large parent firms of production keiretsu in any industry are rare since keiretsu function as safety nets or "insurance schemes" in the case of financial trouble of the parent company (Okimoto 1989, 139). In the case of Mazda motors in the 1970s, for example, when the maker of the rotary engine car nearly went bankrupt, it received help from its keiretsu bank, the Sumitomo Bank and its keiretsu firms, which kept it afloat. Government only indirectly supported Mazda by guaranteeing Sumitomo Bank's solvency. MITI also indirectly supported the rebuilding efforts of Mazda by advising automobile competitors not to take advantage of the situation and by asking the media not to spread negative images of Mazda in order to "help restore consumer confidence" (Genther 1990, 171).

As MITI's influence over decisions of the automobile industry declined, it was forced to change its industrial policy orientation. No longer could it guide industry through pro-production policies in face of the changes in
the industry and the growing international pressures. Reacting to the new environment, MITI's industrial policies shifted to efforts to resolve political conflicts and preserve orderly business. Under the new policy orientation, MITI's actions are today more reactive to internal and external pressures than strategic as they were in earlier years. The new policy orientation of MITI also reflects the fact that automobile makers have become more assertive and less willing follow MITI's guidance. No longer is MITI seen as a buffer against foreign competitors. It now finds itself pressuring producers to limit exports or to increase imports from abroad as a result of foreign political pressure.

The Americans threatened in the early 1980s to increase their import restrictions, either by tariffs or quotas, unless the Japanese agreed to limit their exports and begin to invest in plants in the United States. These demands put MITI in the difficult position of having to persuade Japanese automobile makers to agree to provisions which were perceived as being detrimental to their interests. They strongly opposed voluntary export restriction since the arrangement violated their perception of free trade principles and constituted a form of managed trade. Eventually, the automobile makers, in face of increasing pressures and threats by Americans, were forced to give in to the arrangements negotiated by MITI. MITI was forced to
rely on the threat of America's retaliation in order to get acceptance for voluntary restrictions.

Although the expression "voluntary export constraints" implies voluntary action, the Japanese government was pressured by the American United Automobile Workers (UAW), automobile manufacturers, Congress, and the administration to accept their demands. The increasing conflict over trade imbalance since the 1970s led to a host of demands against Japan throughout the period. United States Senators John Danforth and Lloyd Bentsen, for example, submitted a bill in January 1980 which would have set quotas on Japanese cars if "voluntary export restrictions" were not undertaken (Destler and Sato 1982, 17-18). Leaders of the UAW also urged the American government to find an escape clause in American trade law which would permit measures such as quotas and higher tariffs against imports of Japanese cars into the American market. Demands continued throughout the Reagan administrations for increasing tariffs and placing quotas on Japanese cars. While proclaiming free trade, President Reagan led demands for Japan to compromise and agree to voluntary export constraints. After a series of negotiations between American trade representatives and MITI officials in 1981, a "voluntary limitation" on the export of cars into the United States was agreed to by Japan for a period of three years. The export ceiling for the first year of 1982 was 1.68 million cars (Amaya 1982, 115). This
limitation has been renegotiated and has remained in effect from that time to the present.

Japanese makers began to invest in automobile plants in the United States in the early 1980s. This move of Japanese owned automobile plants to the United States came only after American labor leaders and local and state government officials began to vigorously recruit them. Honda led the way, establishing plants in both Canada and the United States. Other Japanese automobile manufacturers, including Toyota and Nissan, began to invest in these overseas plants since the export limitations on Japanese cars continued. A number of the keiretsu part makers often moved with their parent firms, creating new types of policy challenges for Americans.

Policy Changes and Vertical Keiretsu in the Home Electric Appliance Industry

Since it did not initially constitute a high priority in the governmental economic plans at that time, the Japanese home electric appliance industry did not have close relations with government in the post-war period (Okimoto 1989, 168). High priority industries such as steel, petroleum, or electric power utilities in this early period were aided in creating oligolistic companies which could compete internationally. The key industries receiving governmental support originally included chemicals, steel,
electrical power, and oil refineries. Later on, preferential treatment was expanded to include the automobile and home electric appliance industry.

Development of the industry in the early post-war period, therefore, depended almost entirely on the ability of entrepreneurs who produced radios, tape-recorders, and black and white television sets. Competition was severe, and many went out of business. The number of radio producers, for instance, declined from 80 in 1948 to 18 by 1950 (Baranson 1981, 54-55).

Promotion from government began in the 1950s and the early 1960s. Government, particularly MITI, helped the surviving firms by promoting mergers and concentration of the industry. The number of firms acquiring licenses for the necessary foreign technology was limited by MITI. These governmental actions resulted in concentrating 98.1% of the production of televisions by 1961 in the hands of the 10 strongest manufacturers of black and white television (ibid, 55). Several of these strongest television producers entered into licensing agreements with Western firms. Toshiba, for instance, was licensed by General Electric, Hitachi by RCA, and Matsushita by Philips. MITI also assisted these selected firms by lending funds at a lower interest rate than available otherwise and through tax exemptions on imports of foreign components or technology (Miyazaki 1983, 151). Also "short-term export credit" was
made available from banks at "preferential rates" under legislation to promote research and development in the consumer electronic industry (Baranson 1981, 71).

Formal import protection of the home electric industry through high tariffs and quotas was permitted in the early postwar period because the United States encouraged such protective practices due in part through fear and concern over the expansion of influence by the Soviet Union during the Cold War period. Even after Japan joined the International organizations supporting liberalization of trade, such as IMF, OECD, and GATT, it continued to protect the consumer electronic industry through high tariffs on color televisions until the 1970s.

Comparative tariff rates from 1965 through 1970 showed that Japan's tariffs on television were 30% of costs while tariffs in the United States were only 10% in 1965, 9% in 1968, and 7% in 1970 (ibid, 63-64). The Japanese government also protected this industry until 1969 by limiting the percentage of capital that foreigners could buy in these firms (ibid, 65). After attaining international competitiveness by the early 1970s, the Japanese government's role shifted to the role of preserving orderly development.

A rapid surge of imports of cheaper Japanese television sets into the American market began in the 1960s with first black and white sets, followed by color television. This
flood of Japanese electronic products, particularly the color television, had a devastating effect on the domestic television industry. The number of American television producers declined from 27 firms in 1960 to five producers in 1980, and only three of these companies—General Electric, Zenith, and RCA—were competitive with the Japanese (Yamamura and Vanderberg 1986, 259). Employment in the industry followed suit and dropped by 50% between 1966 and 1970 (ibid, 258). Political opposition to Japanese imports increased and intensified as the numbers of imported Japanese products grew. American industry and labor both petitioned government to restrict Japanese products. They claimed that Japan was unfairly dumping products in the United States. Investigations were made in over 20 cases between 1970 and 1981 by the United States. As a result, MITI was forced to respond to these claims. In an attempt to alleviate this pressure, MITI advised Japanese television makers to set firm sales prices on all its exports in order to avoid the charge of dumping. The Japanese government hoped to minimize damage of these charges by reducing the bargaining and discounting of prices which America criticized so severely.

The Trade Commission in 1977, on the other hand, went along with the disgruntled American producers and recommended raising the tariff in order to help American producers. The Carter administration, which preferred not
to reopen a trade war and violate liberal trade principles worked for a self-imposed limitation by the Japanese (The Institute of Social Science, University of Tokyo 1990, 98). After much negotiations between the two governments, an agreement was finally reached to set a ceiling on Japanese exports of television sets into the American market. This agreement limited imports of the Japanese color television receivers and their components for three years beginning in 1977 (ibid). The countries subsequently tried to extend the Orderly Marketing Agreement (OMA) but failed because exports fell below the OMA's limit. The effect of this limit on exports was somewhat similar to the voluntary limitation on exports of automobiles.

In an unexpected result of these policies, some Japanese manufacturers began to establish plants in the United States. Matsushita and Sanyo invested in plants in the period from 1972 to 1976. Limitations set by OMA triggered six other Japanese electronic companies, including Mitsubishi Electronic, Sharp, Toshiba, and Hitachi, to begin production in the United States after 1977. This mass movement of Japanese firms to America resulted in the new Japanese plants in America substituting their products for imported television sets which were blocked by the OMA agreement. Rising protectionism and the charges of dumping thus failed to keep Japanese products from entering the American market.
In addition, the Japanese firms foresaw a possibility of further expansion in the American market. Also, the continuing rise of the yen and the increasing cost of energy and transportation as a result of oil crises narrowed the cost differences in production between the United States and Japan (Baranson 1981, 81-85) and made it economically profitable to produce goods in America. These transplanted companies hoped to expand the market not only for color televisions but for other electronic products such as video tape recorders, microwave ovens, video discs, etc. Another reason for moving their operations to the United States was that it was the only alternative left. Using Taiwan or South Korea as bases from which to send products into the American market was no longer possible after the OMA agreement was extended to them in 1978.

Political tension over electronic products in the American market largely subsided after Japanese firms began local production in the United States, unlike the experience in the automobile industry. This may be explained in part by Japanese firms virtually dominating the electronic products market manufacturing goods such as televisions and VCRs in the American market. Zenith remains the only remaining American television maker still producing televisions. Also, electronic parts are much more standardized than automobile parts, and therefore, these new firms did not bring keiretsu firms to produce their parts
but rather purchased from local part makers. There was little of the debate over the parentage of televisions parts like there was in the automobile industry since under the OMA agreement if over 50% total value of a product is made in the United States, the product is considered to be an American product. Products of Japanese owned firms in the United States, therefore, are considered to be American-made and thus do not create much political conflict.

The computer industry is another area of discord between Japan and the United States. Trade tensions between the United States and Japan centered on standardized electronic parts, such as chips and semi-conductors. Much of this technology was developed in America, which dominated the world market for these essential electronic parts without serious competition until the early 1970s. In the mid 1970s, the Japanese government began to encourage the development of the computer industry. Through the Provisional Measures Law for Promotion of Specific Machinery and Information Industry of 1978, the government encouraged growth of the computer industry. Many of the same kinds of programs as had been used for other industries were used to guide and assist industries develop in this field. Since most firms in this new field already were established home electric appliance producers, the computer industry developed rapidly and soon controlled approximately the same share of the world's market as the United States. As this
As the Japanese computer industry developed and grew competitive, the government's role tended to change as it had in the case of automobile and televisions. Its role in the computer industry no longer is directed solely to production and has become internationally competitive since most Japanese computer manufacturers, such as Toshiba and Hitachi, are fully developed with production keiretsu. The role of government has shifted to resolving international conflicts and to preserving orderly development. Resolving the conflict arising from external pressures and helping to open new Japanese markets abroad are the main roles of MITI in this field. MITI again is in the position of attempting to get Japanese industries to undertake programs which they believe are detrimental to their interests. For example, the 1986 agreement in which the Japanese government agreed to increase American based producers a share of the Japanese market for computer parts, such as chips and semi-conductors to 20% of the total Japanese market within five years (Destler 1992, 128) has not been met despite MITI's cajoling, and it remains a festering problem between the two countries.
Conclusion

The Japanese industrial structure, built upon close intercorporate groupings or keiretsu, directly affects the government's industrial policies and their politics. As the structure developed after World War II, the government lost the ability to reorganize and guide industry in ways it preferred. The parent manufacturers supported by their keiretsu firms have real political clout to prevent programs which are seen as detrimental. Despite the growing international pressures for Japan to liberalize its markets in order to reduce the imbalance of trade, the affected companies and their keiretsu firms are able to resist direct government action and threats, as can be seen in cases of automobiles, electric and electronic appliances, and computers.
CHAPTER VIII

SUMMARY AND CONCLUSION

Although keiretsu recently have become an important point of debate in the conflict between the United States and Japan, confusion abounds about their nature and how they influence industrial and trade policies. Most writers still refer to keiretsu as the six large horizontally linked corporate groups or "kigyo shudan" in Japanese. This definition ignores the fact that there are also vertically linked groups of firms or "kigyo keiretsu." The confusion is further magnified by the fact that different names are often used to specific particular kind of economic groupings, such as "kinyu" or "yushi" keiretsu for financial or banking groups. Keiretsu are so bound up with the political economy of Japan that it is difficult to separate the phenomenon from economics or politics. Defining keiretsu is one of the main obstacles to the study of this political and economic phenomena, and how they influence economics and the policy process.

Keiretsu are defined in this study as a special type of grouping or collaboration of two or more legally independent companies. The ties between the member firms may involve special institutional arrangements such as intercorporate share-holding and inter-mingling of directors between firms,
and they may rest mainly on close social relations between members in the firms. Social clubs of firms in a keiretsu, such as the president's club and the corporative suppliers' associations, are institutional means of getting people together to socialize and conduct business in an informal setting. Developing close social ties are a vital part of these intercorporate groupings. Although keiretsu create a type of network of independent firms, they may be differentiated from other types of groupings such as informational exchange networks, conglomerates, and zaibatsu. Each of these type of industrial groupings may be differentiated since they participate and affect public policy differently. The significance of attempting to differentiate keiretsu from other types of economic ties between industrial firms, therefore, is essential to an understanding of the modern structure and dynamics of the Japanese political economy. Keiretsu are not merely networks for information exchange but are special institutional arrangements which help shape and control the economy and the policy processes in Japan.

The lack of understanding of the development of keiretsu is one of the obstacles to an appreciation of the complexities of the Japanese political economy. Explanations for the development of the keiretsu phenomenon have stressed economics, culture, and legal and institutional aspects of the society as the cause for the
rise of these groups. Economic factors, for example, typically suggest that keiretsu developed because of economic needs of the nation after World War II. Companies were encouraged in the postwar economic growth period to join in groups in order to coordinate their businesses and resolve potential competitive conflicts so that all could share in the benefits of economic growth. Others stress the influence of cultural factors as the reason for the rise of these intercorporate groupings. They emphasize that the group mentality or the group-oriented culture of Japan creates an environment which encourages these groupings. Keiretsu, according to this cultural view, fits the Japanese tradition of stressing the importance of the group where everyone has his or her place as in a family and owes loyalty to the group (Haitani 1976, 124).

Still others suggest that business laws and regulations about intercorporate relations and monopoly practices contributed to the formation of keiretsu after World War II. The rise of keiretsu as a new type of business arrangement was made possible because of lenient application and regulatory practices of anti-monopoly laws and the provisions pertaining to such practices as intercorporate share-holding, group financing and inter-company directorships.

None of these explanations for the rise of keiretsu, however, considered the broad political context of
industrial-governmental relations or the dynamics of politics in Japan as this study does. Traditionally, the Japanese government has not opposed monopolies. There is no tradition of political movements against monopoly as in the United States. In fact, the Japanese government has long had a pro-business orientation. The prewar precedents of supporting oligopolistic zaibatsu and the government's activities of directing or participating in the economy provided a pattern for actions after World War II. After the war, the economic and political climate encouraged Japanese firms, especially large firms, to participate in oligopolistic business arrangements through mergers or subcontracting ties between large manufacturing firms and small companies to enable them to compete with foreign companies and to prevent possible foreign take-overs. In these years, government felt the need to encourage mergers and intercorporate arrangements because of the fragile nature of the dual structure of the Japanese economy.

The economy of Japan since the Meiji Restoration in 1868 has consisted of a few strong large firms and a large number of weak small and medium sized firms which had little hope of surviving under free competition. Government ministries, especially economic ministries, such as the Ministry of International Trade and Industry (MITI), encouraged mergers and creation of intercorporate ties by making financial assistance available through loans from
governmental institutions and by refusing to enforce vigorously the anti-monopoly law which was enacted as a result of American occupation. The reinstitution of oligopolistic business practices was not challenged by the United States at that time because of the rise of the Cold War and the belief that Japan was needed to provide stability in the region and to help contain the spread of communism.

Creation of vertical keiretsu was believed by both governmental planners and industrial leaders to be a means of providing economic stability and security for both the parent firms and small and medium sized subcontracting companies. The keiretsu network of firms also was thought to serve as a buffer against economic fluctuations and arrangement for promoting technological improvements and efficiencies in operations. In both the automobile and home electric appliance industries, vertical production and distribution keiretsu were found in the case studies to have had both positive and negative impact on the domestic and international economy.

Production keiretsu in the automobile and home electric appliance industries promoted technological improvements and improved quality at the same time they reduced cost of production. The advantages of these types of industrial relationships for the parent firms are obvious from the economic miracle which occurred in the Japanese automobile
and home electric appliance industries. These keiretsu also provided economic stability from fluctuations in the market for the parent firms and to a lesser degree to the subcontracting firms. The close working and social relationships between members of the parent firms and the subcontractors in the keiretsu promote continuous exchange of information and innovative ideas which help to improve quality and to reduce cost. It enables the keiretsu firms to plan together and to experiment with management techniques such as the just-in-time production system.

There are economic problems, however, for the firms in a production keiretsu of being so closely bound together. While each firm has a common interest, each firm also has its own interests which may conflict. Parent firms may act in ways detrimental to the subcontractor's interest since the subcontracting firms are dependent on them for their existence. During periods of economic crisis and downturns, the subcontracting firms may become victims of a profit margin squeeze by their parent firms. There are a number of examples in the automobile and the home electric appliance industries of the parent firms taking actions which harmed subcontracting firms. As a result of the inflation caused by the oil crises in the 1970s, the main Japanese automobile manufacturers forced their keiretsu subcontractors to absorb the inflationary price increases. This was a very painful experience for the subcontracting firms and the government.
for it was one of the few times in history that the government enforced anti-monopoly provisions about price fixing in a manner which restricted the large manufacturing firms. Although the changes ultimately resulted in a more cost effective method of doing business, the pain and burden of change was borne mainly by the subcontracting firms.

More recently in 1985 the automobile manufacturers again forced their keiretsu firms to cover the losses resulting from the reevaluation of major currencies which the American government insisted on as a means of increasing the competitiveness of American made products. The Japanese automobile manufacturers, in response, mandated that their subcontractors lower the cost of production of parts by an amount equal to the change in the value of the yen. Cost reduction demands by parent companies resulted in fewer orders to keiretsu companies at the lower levels since the upper tiers of keiretsu firms began to perform their roles in the production process as a means of keeping business and protecting themselves. Often the lower tiered keiretsu firms were forced into bankruptcy and out of business by such actions.

In the home electric appliance industry, a similar pattern of use of power by the parent manufacturer over its subcontracting production firms occurred in the period of the oil crises. The reevaluation of the yen in 1985, however, did not injure the television and electronic
manufacturers as much as it did the automobile makers since the Japanese television and electronic manufacturers had already opened plants in the United States so the new rates of exchange did not affect their competitiveness.

Parent firms, as a result of the keiretsu ties, may also force management practices on their subcontracting firms which are to the advantage mainly of the manufacturers and not the parts suppliers. The just-in-time production system used in both the automobile and home electric appliance industries is an example. The just-in-time production technique, which reduces cost for the parent company, may have a negative side effect for subcontracting companies. Keeping less inventory of auto or electronic parts at a parent firm's facility means that a larger inventory must be stored at the keiretsu part suppliers. The part makers also may be forced to invest in additional machinery to assure that they can be ready to supply the different types of parts upon orders from their parent manufacturers with little advance notice.

Most significantly, production keiretsu in both the automobile and home electric appliance industries tend to exclude outsiders from the business. This seriously affects both domestic and foreign competitors. Both Japanese and foreign companies which are interested in supplying parts for automobiles or electronic products are virtually excluded from competing with keiretsu suppliers. This is
especially true for automobile parts which are not as standardized as electronic parts. Honda motors, for example, still imports to its American manufacturing plants key parts such as engines and related items from Japan. Competitors in both Japan and the United States find it difficult to sell their products directly to major Japanese automobile makers because of the keiretsu ties. It is almost impossible for Japanese automobile makers to make decisions pertaining to contracts with non-keiretsu part suppliers based on lower cost alone since the ties of trust and reliance between a parent automobile maker and its keiretsu suppliers, especially the first-tier firms, represents years of working and investing together in technology and management.

Distribution keiretsu in the automobile and home electric appliance industries originally grew out of the need for manufacturers to market their products. In the automobile industry immediately after World War II, the distribution system was undeveloped. The creation of the network of distribution keiretsu was an attempt by manufacturers to follow the franchise system used so well in the United States. As distribution keiretsu developed, they served the need of manufacturers quite well. In the home electric appliance industry, formation of distribution keiretsu by manufacturers had begun in the prewar period to bolster prices and to promote business stability of
manufacturers. The market often faced problems of excessive competition and discounting of prices by independent wholesalers and retailers, especially at the time of worldwide depression. Manufacturers attempted to gain control over pricing by strengthening their sales network through keiretsu ties and by designating keiretsu wholesalers. In the post-war economic boom in the 1950s, keiretsu retail and wholesale firms were aided by the manufacturers with capital and managerial expertise. These actions laid the foundation of the present distribution keiretsu in the home electric appliance industry.

A number of advantages accrued to manufacturers from distribution keiretsu. Manufacturers, as a result of their distribution keiretsu networks, are able to project the size of the domestic market through the volume of products sold by members. They are also able to ensure that dealers concentrate their sales efforts on the products which the manufacturer wants to emphasize since the manufacturers are able to designate which models can be sold in specified territories. Car manufacturers, for example, can prevent dealers from promoting only high margin models or from discounting products by giving bonuses for sales of particular cars and by controlling sales rights in designated areas. In the case of both the automobile and the home electric appliance industries, manufacturers also can ensure customers' service through their keiretsu dealers.
or retailers. Retailers and manufacturers pay close attention not only to the market share of a particular model of their products but also to the service level which promotes confidence and trust of their customers. Complaints and suggestions by customers at these retail outlets are referred back to the manufacturers so that they can respond to the customers' needs and make needed adjustments in the design of the cars or electronic products.

There also are a number of advantages for retail firms to belong to a keiretsu. Parent manufacturers often offer sales incentives, such as bonuses and commissions as well as reductions in wholesale prices, for extra sales of their products. The retailers also may receive managerial and financial assistance from their parent firms. Their profit margins also are protected by the size of the exclusive sales territories and the designation of models which different retailers may sell. The parent manufacturer can assure a profitable market to retailers who belong in the circle.

There are, however, negative aspects for retail firms belonging to a keiretsu despite the advantages promised. Keiretsu retailers in both the automobile and home electric appliance industries have less autonomy than a purely independent firm, and there are incentives and pressure on them to sell more products of the keiretsu parent
manufacturer. The sales goals and the volume of products purchased from the manufacturer of keiretsu retailers are largely mandated by the manufacturers. Despite the fact that sales quotas and the practice of demanding "blank promissory notes" or pre signed blank checks from the retail outlets was outlawed by regulatory agencies, the superior position of parent manufacturers still permits them to dictate sales goals of their retail keiretsu firms. Manufacturers, especially in the home electric industry, can manipulate to a large degree prices of their products at the retail level through various incentives, such as giving recompenses or "kickbacks" and bonuses for accepting their products at the keiretsu retail stores.

Entry of new retail or wholesale distributors into the Japanese market is very difficult because of the presence of existing distribution keiretsu. Domestic and foreign companies attempting to open major outlets in competition with existing keiretsu dealers find that it is not only costly and economically risky but also administratively very difficult. For example, since most of the keiretsu retailers of the home electric appliance industry are small mom-and-pop stores which are very vulnerable to competition from large volume stores or supermarkets, they traditionally resist entry of all new competitors. As a result of the Large Scale Retail Store Law, the local Chambers of Commerce, which is dominated by the small scale local retail
dealers, has a virtual veto over the opening of new businesses in their locales. It is, therefore, almost impossible to get administrative approval to open large scale stores without a very long period of waiting, in the past up to 10 years. Similarly, it is very costly and economically risky for foreign car manufacturers to open automobile dealerships and essential service facilities. Foreign car makers as a result are often forced to rely on existing distribution keiretsu dealers of major Japanese car makers to distribute their cars in Japan since there are extensive outlets of keiretsu dealers effectively blocking newcomers. This situation has led to growing demands, especially from American car makers, for the setting of goals or targets for the selling of foreign cars through keiretsu dealers of Japanese automobile makers.

The transformation of the economic and political environments of keiretsu over the past two decades has resulted in changes in vertical keiretsu. Parent manufacturers in both the home electric appliance and automobile industries have been forced to become more selective in supporting keiretsu firms and have attempted to reduce their dependency generally. In fact, the number of firms in keiretsu has been reduced. After the oil crises parent firms in the home electric appliance industry increasingly were forced to distance themselves from production keiretsu firms and to permit these subcontractors
to diversify their businesses so that they would not be as dependent on the keiretsu. Automation has made it possible for parent manufacturers and a few key suppliers to produce their own parts and as a result the inefficient firms in the keiretsu have been dropped. Competition among parts manufacturers has increased as most parts in the electric appliance industry have become standardized and highly automated. Production keiretsu in the automobile industry also have been forced to change and reshuffle their members, including some first-layer firms. The increasing political pressure of American auto parts makers to use more local auto parts and the moving of Japanese production facilities to the United States since the early 1980s have created a survival crises for many lesser tiered keiretsu auto parts suppliers in Japan. Furthermore, the recent economic downturn in the domestic and world economy since the end of the 1980s has forced automobile manufacturers to reorganize and reduce the number of keiretsu members, especially those firms in the second-and third-layer firms. Recent decisions by Japanese automobile makers to increase purchases of local auto parts in the United States from the level of 50% per car in 1990 to about 70% in 1994 threatens further keiretsu suppliers.

Changes in the domestic and international environments during the past two decades has also resulted in a transformation in distribution keiretsu. Distribution
keiretsu in both the automobile and home electric appliance industries have been hard pressed by the rate of change. Many keiretsu dealers have not been able to adjust and have been forced out of business. The decline in the demand for new cars in Japan in the 1970s as a result of economic downturn following the Arab oil embargo was followed in the 1980s by a saturation of demand for new cars in the domestic market. The decline in domestic sales seriously threatened the automobile industry and its distribution keiretsu firms. The Japanese automobile industry was able to compensate for the domestic decline in sales because of the increased demand for small Japanese cars in the United States. The domestic marketing strategy of Japanese automobile manufacturers, however, changed from traditional sales promotion by a large numbers of keiretsu dealers to consolidation of sales efforts in a few dealers. The strategy is to reduce the number of dealers in keiretsu which have relied on door-to-door sales technique and move to a showroom type of sales similar to that of the United States. The sales network of keiretsu dealers of major domestic car makers still dominates the car market in Japan, although some foreign car makers such as Mercedes Benz, and BMW, have created their own distribution outlets, and Japanese independent firms and individuals have begun to import foreign cars directly from overseas dealers. Foreign automobile makers, however, still are largely dependent on
keiretsu dealers of Japanese car manufacturers to sell the majority of their cars.

In contrast to the changes in the automobile distribution keiretsu in the past two decades, change in the distribution keiretsu in the home electric appliance industry has been even more dramatic. The entry of mass sales stores has caused a rapid decline in the number of keiretsu stores. In 1977 keiretsu retailers made up 80% of the total retail shops in the country. Their percentage declined to 40% in 1992, and it is projected that the decline will continue to only 25% by the year 2000 (Wakasa 1991, 42). The "mom-and-pop" keiretsu stores generally are unable to compete with the new supermarkets and mass sale stores. In fact, keiretsu wholesalers are under extreme economic pressure to sell their products to these new types of large volume stores at a discount.

These changes in the methods of retailing merchandise have caused manufacturers to become more defensive and to take steps to protect themselves and their keiretsu retailers from competition of mass sales stores. They have become more selective in designating core keiretsu shops to receive assistance through rebates, subsidies and other financial and managerial assistance. These actions were taken in order to better protect their keiretsu retailers.

Although most keiretsu retailers still obtain some form of assistance from their parent manufacturers, the recent
economic recession is seriously affecting their ability to support all of these firms. Furthermore, the increase of imports by supermarkets and mass sales stores of electric and electronic products from the newly industrialized countries such as Taiwan, Singapore, and South Korea aggravates the problem of competition for keiretsu retailers. The supermarkets can sell at much lower price than keiretsu retailers who often are prohibited by manufacturers from discounting prices. As a result, the economic viability of keiretsu retail stores in the home electric appliance industry is seriously challenged. Their reliance on various rebates and commissions, as well as delaying tactics against the building of new stores in their trade territories through the use of the Large Scale Retail Store Law, is the main reason keeping many of them in business today. Actions to resist introduction of modern retail stores are becoming more ineffective, however, as political opposition to the regulation rises and the popularity of mass sale stores increases among consumers. Keiretsu retailers increasingly find that there is little market left for them, and this portends a dim future for keiretsu retailers in the home electric appliance industry.

As the case studies show, the growth and development of vertical keiretsu is an intricate part of the political economy of Japan. Industrial policies of Japan cannot fully be understood without taking them into consideration. Up to
the present, scholars have not considered industrial groups or vertical keiretsu as major actors in the Japanese political process.

The case studies show that vertical keiretsu in the automobile and home electric appliance industries have been involved in shaping industrial policies since the early post war years. Although the relations between government and these industrial groups have changed from consensual to conflictive as they have developed, they have been involved in shaping the political economy and in affecting public policies throughout the post war period.

In the immediate post war period, there was little consensus on how to rebuild the economy, except for heavy industries. Home electric appliance and automobiles became part of the government's economic development plans only as the actions of private entrepreneurs from these industries came to be noticed by key governmental officials as the industries began to grow. The automobile and home electric appliance industries readily agreed to the industrial policies proposed by government, such as tariff protection and restrictions on foreign acquisition of capital, in these new industries since these measures were seen as aiding them. MITI's actions rejecting strict enforcement of the Anti-monopoly law also worked to the advantage of keiretsu and their manufacturers.

Relations between these industrial sectors and
government changed from cooperative to conflictive, however, once the industries began to develop and government began to propose measures which were considered to be against their interest. Resistance to governmental industrial policies and plans often came from the large manufacturers supported by their keiretsu firms. For instance, the government's reorganization plans of the automobile industry in the 1960s, which called for fewer car makers in order to make them more competitive internationally, was vigorously opposed by the manufacturers and their keiretsu firms. Evidence of the power of keiretsu can be seen in that the government was forced to retreat on this policy. In another instance, automobile makers and their keiretsu firms resisted MITI's plan of consolidation of the industry according to various type of vehicles because it threatened their autonomy. Again the government was forced to abandon this proposal.

Still another instance of political disharmony and conflict between government and manufacturers and their keiretsu firms arose over the governmental ruling and limitations on the percentage of investments foreigners can make in Japanese businesses. These issues emerged as a number of joint ventures with American automobile firms were being considered by various Japanese car makers. Although administrative guidance stated that foreign investments could not exceed 30% of total capital, Mitsubishi motors and
other Japanese automobile makers refused to follow this guidance when it appeared to be to their advantage not to do so. Politically they were powerful enough to openly defy MITI when they thought government was interfering with their business.

The increasing pressure of change in the domestic and international environment also has forced government to take actions for containing and resolving domestic and international conflicts. Domestically, its pro-production stance occasionally has been challenged by the growing interests of consumers against business practices of manufacturers and their keiretsu firms. One example occurred during the oil crisis of the 1970s. As a result of shortages of all kinds of products which led to inflated prices, consumer groups, mainly housewives, challenged the actions of manufacturers and their keiretsu distributors which they claimed were keeping products off the market in order to inflate prices. The conflict between these two opposing interests was resolved when government took action to enforce the anti-monopoly law. Also during the 1970s industrial pollution became a major political issue. Again, environmental and consumer groups challenged the pro-business attitudes of government. The preference of the manufacturers and their keiretsu production firms again lost, and stricter anti-pollution measures were enacted.

The increasing pressures from the international
community to redress the trade imbalance situation between Japan and its trading partners, meanwhile, forced MITI to change its orientation of export promotion to more of a stance promoting importation of industrial goods. Although Japan’s formal trade barriers by the early 1980s, such as quotas and tariffs on industrial goods, were among the lowest for industrial countries, its low ratio of imports of industrial goods became a point of contention with other industrial countries, especially the United States. Protests and demands that Japan reciprocate by opening their market to foreign goods forced the Japanese government to attempt to reach a political agreement to promote the sale of more foreign goods in Japan and to voluntarily limit its exports. Under this new policy, MITI’s role increasingly has become more of a mediator in the trade conflict between foreign trading partners and the industrial sector of Japan. As MITI’s position has shifted to a more internationalist stance and as it has had to accommodate more interests of Japanese consumers, other traditionally oriented ministries, such as the Ministry of Finance (MOF) and the Ministry of Agriculture, Forestry and Fisheries (MOAFF) continued to resist trade liberalization in those areas within their jurisdiction, such as banking and agriculture. Their resistance to opening Japan grows largely from the pervasive fear of a foreign takeover or the subordination of the Japanese economy. There continues to be a national
uneasiness about economic insecurity, despite the huge trade surplus and the growing recognition of MITI and others that opening Japanese markets may better serve consumers and promote long term development of the country. There also remains a sense of anxiety and urgency among industrial ministries that Japan should catch up and surpass leading producers of foreign countries in all promising industries, especially in high technology such as IBM in computers and AT&T in communications. This compulsion among career bureaucrats to excel, and their pride in guiding the Japanese economy, moderates the new international position of MITI so that it does not necessarily mean that the Japanese government is moving toward a totally free market or that it has abandoned the mentality of catching up with the West.

As a result of these cultural attitudes, responses to the demands of its foreign trading partners are made only grudgingly, since they not only rekindle the nation's psychic fears among conservative bureaucracies and special interest groups, such as bankers' and farmers' associations, but also threaten the fundamental structural arrangement of the economy, i.e., vertical and horizontal keiretsu. As the keiretsu structure has gained economic power, they also have increased their political power. The fact is that the chief executives of major keiretsu manufacturing firms now hold key positions in the major economic interest groups such as
the Federation of Economic Organization or "Keidanren."

Interest groups traditionally donate campaign funds to major political parties, especially to the dominant party, the Liberal Democratic Party, in order that they may have access to influence public policy. New proposals for opening the Japanese market, such as the recent proposals by the American administration calling for reciprocity and specific numerical targets for trade are strongly resisted by business interest groups, the parent manufacturers, and their vertical keiretsu firms. The proposal for reciprocity with specific purchase and import targets, it is angrily claimed, constitutes managed trade rather than free trade.

Although Japanese business interests profess a belief in free trade, there remains a major argument with Japan's trading partners of whether the industrial structure of keiretsu is compatible with free trade. This is the essence of the conflict in the bilateral trade negotiations between the United States and Japan. As serious as these differences between Japan and the United States are, this type of conflict with other nations promises to become even more pervasive as the world economy develops and there are greater trade interactions among countries with different political economies. The great differences between political and economic structures, as well as the cultural values and history shaping the political economies of nations, inherently will cause greater international
conflict between them.

This study found that vertical keiretsu are major actors influencing directly both the domestic and foreign policies of the Japanese government. This contrasts from the traditional view about international relations. Traditionally the field of international relations has focused almost entirely on security matter, and nation states were considered as the sole and dominant actor. Only the more recently the pluralist school acknowledged the importance of non-security or economic issues on international relations. Unfortunately this school emphasized mainly patterns of cooperation and international regimes which evolved from the increasing interaction of rational nation-states, and failed to consider the growing international problems and conflict between industrial states. International conflict was not generally considered by the pluralists because it countered their view that international norms and principles were evolving as people and states developed rational patterns of interaction. Although this group of scholars recognized the significance of transnational actors, such as the multinational corporations and international terrorists, they did not consider domestic politics or sub-national actors as major actors in foreign policy behavior. Unlike this view, this study found that the economic conflict evident in the bilateral relations between Japan and the United States is
directly influenced by the domestic political economy of Japan, and particularly by vertical keiretsu.

None of the four best known models of Japan's political economy, the neo-classical economic, Japan Incorporated, the pluralist industrial policy, and the reactionary ad-hoc policy models, recognize that keiretsu vitally affect its politics and economics. This is a serious flaw in their conceptualizations. The structure of Japan's economy and politics cannot be fully explicated, and the economic and political processes fully understood without an adequate model or conceptualization of the political economy.

To develop a realistic model requires an appreciation of the cultural values which influence government to become involved in the economy, and an understanding of how government was involved in the early stages of industry. Chalmers Johnson's model or the Japan Incorporated conceptualization offers insights on this phase of the evolving political economy after the World War II. A satisfactory model of Japan's political economy also needs to elaborate how government is involved in the economy, since industry has become internationally competitive and much more politicized. Calder's reactionary ad-hoc model is useful for explaining policy-making in the recent period. Furthermore, a model of Japan's political economy needs to be able to clarify the political and economic dimensions of keiretsu firms. How do they interact economically and
politically in the domestic and foreign markets? Although none of the extant models acknowledge the importance of keiretsu, some of the process orientation found in the pluralistic industrial conceptualization may be useful in identifying the dynamics of these industrial group. While these suggestions may contribute to building a model of Japan's political economy, there must be a full recognition of the fact that the political and economic structure rests on the keiretsu.

One final observation arises from this study. As the world economy is bound ever closer, conflicts that inevitably will occur, requiring an understanding of the barricaded political economies around the world. At present, the no adequate comprehensive methodology to study the differences in the political economies around the world, or how they may affect the new international relations. This seems to be an area for social scientists to address and rectify.


Consultants.


Princeton University Press.


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