

Part I: Two Consecutive Years Preparing the White Paper on International Trade – Thoughts on the Perspective and the Message –

By Hisatake Masato

It has been my good fortune to be responsible for preparing the *White Paper on International Trade* last year and again this year. Looking back on these two years, I feel it would be appropriate to explain my thoughts regarding this work, and what I have attempted to communicate. Let me start by discussing my analytical perspective and the message that I have sought to communicate with the two White Papers.

1. Analytical Perspective

My analysis last year was carried out from the perspective of “agglomeration,” while the perspective this year is “institutions.” Below I shall explain the importance of each of these phenomena. (Fig. 1)

Economic growth is one of the most important goals of economic policy. Economic growth is determined by the formation of physical capital, the formation of human capital and innovation. In other words, economic growth depends on capital and labor inputs, and on how these are utilized for the purpose of production and innovation.

Within this process, decisions regarding the input of capital and labor concern the question of how to allocate capital and labor. There are generally two methods of capital allocation. The first method is through the market; the second is through organizations. In the market, prices determine the allocation of resources based on the result of competition between trading entities. Within organizations such as firms, however, resource allocation is determined on the basis of authority.

Economic growth is determined by the interaction between: (1) the resource allocations toward capital and labor, on the one hand; and (2) the innovation that makes use of these factors. In recent years, we have seen the emergence of an increasingly keen awareness concerning the important impact of “institutions” upon this process. Economic historians, especially those engaged in the new field

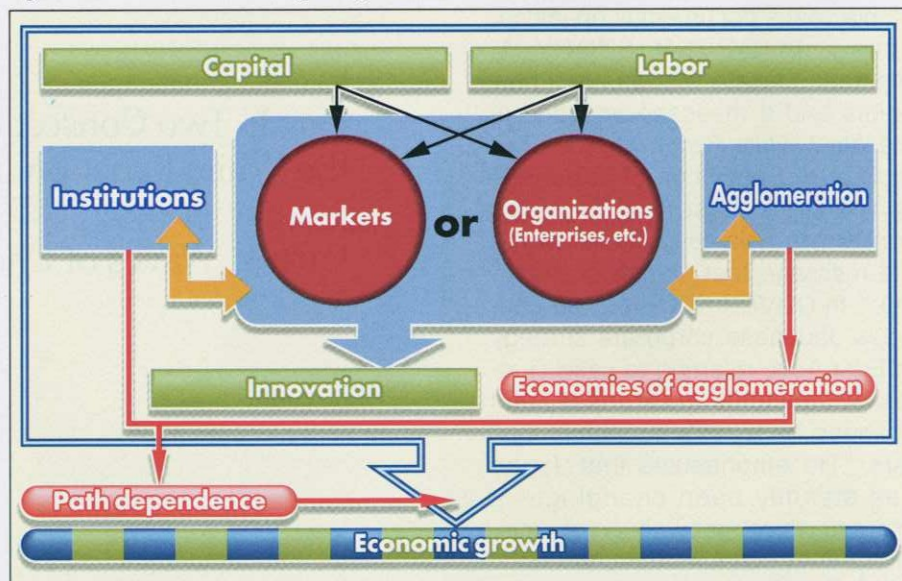
known as “history of institutions and economies,” stress the influence of incentive structures such as investment and innovation, and argue that economic disparity arises from the path dependence of institutional rules.

According to Douglass North, for example, an institution is a set of game rules, which can be either formal or informal. Formal rules consist of regular legal institutions (such as customs duties, contract law and laws governing investment) and a country’s basic law (i.e., its constitution). Informal rules dictate the things that are determined according to custom, and are sometimes referred to as culture or cultural climates. The former, being expressly formulated, can be borrowed from outside, but where the latter remain unchanged, they will render borrowed (formal) institutions inoperable. An institution could well be thought of as common understandings on the way a game seems to be played among all the players that are consisted of organizations and individuals. This view of institutions is frequently put forward with respect to

East Asia, and a group of scholars represented most prominently by Aoki Masahiko have shed considerable light on the situation in Japan and the East Asian region (Aoki, World Bank).

In addition, an important new concept related to economic growth – one that stresses the role of increasing returns – has arisen in the field of economic geography. Changes in transport costs – defined in its broadest sense as costs related to distance – interact with economy of scale to produce new industrial and economic maps. Where transport costs are extremely high, economic activities are scattered and isolated; where transport costs are extremely low, it makes little difference where an enterprise is located, and this also leads to scattering. But where transport costs are somewhere in between these two extremes, “agglomeration” becomes a highly likely occurrence. Agglomeration is the union of organizations and individuals (putting aside for the moment the question of whether atom-like enterprises qualify as organizations). The geographic concentration associated

Figure 1 Decision Process Regarding Economic Growth



with economic agglomeration generates a certain dynamism. But what exactly is this phenomenon?

A common thread running through this “new spatial economics” thus far is the idea of the occurrence of agglomeration as a result of the interaction between: (1) economy of scale in the production of goods and services; (2) the cost of transporting goods; and (3) the diversity of goods and people.

Firstly, the term “economy of scale” refers to the productivity phenomenon whereby production volume per unit of factors of production increases as an enterprise or industry increases in size. This phenomenon can also be thought of as “decreasing costs.” Scholars of agglomeration argue, however, that a more important role is played by a number of economies of scale generated by externalities. Alfred Marshall, after whom the concept of “Marshallian externalities” is named, pointed out three external factors which will cause agglomeration: (1) a labor pool with special skills, created by geographic concentration in a specific industry; (2) the formation by specialized enterprises of a labor-division network; and (3) an ease of innovation caused by geographic concentration of related industries. The idea of ties between enterprises and industries, the importance of which is so highly stressed in the concept of Marshallian externalities, is most easily understood in terms of two constituent components, i.e. “forward linkage” and “backward linkage,” which feed upon each other in healthy symbiosis. To wit, when agglomeration occurs in a particular industry, specialized enterprises, which produce a wide variety of intermediate inputs, come together in close geographic proximity and form a labor-division network. This is the backward linkage. As a consequence, the productivity of industries that make use of such intermediate inputs is enhanced, and the enterprises active in the said industry undergo further agglomeration. This is forward linkage.

Secondly, “transport costs” include more than just the narrowly defined “cost of transporting goods across distances.” In addition, the term must also be understood in a broader sense to include distribution expenses, costs associated with the movement of labor and information, customs duties levied on import goods and

ease of access to markets. At the global level, with its extremely high transport costs, it is appropriate, given the difficulty of movement of goods, that production be evenly distributed among the world’s various consumption areas. Consequently, geographic concentration of production does not occur. Conversely, where transport costs are extremely low, due to the lack of obstacles to movement, there is no mechanism for enterprise clusters to come together in close proximity. Accordingly, transport costs at a certain level will have an effect on agglomeration.

And finally, variety in goods and persons is beneficial. Variety is conducive, for example, to the concentration of consumers in cities, and to the agglomeration of enterprises in cities where consumers are numerous. Moreover, in addition to the formation of agglomeration areas as the result of trading of goods in the marketplace, the agglomeration of industries in particular cities and regions is also abetted by interaction among non-market, or human, factors, and this interaction constitutes another important externality. Marshall and Saxenian have stressed that face-to-face communication plays a significant role in the regional agglomeration of specific types of enterprises and in technological innovation, and they argue the importance of externalities predicated on human variety.

Even without the influence of institutions and economic policy, agglomeration forces, which work their influence through a wide range of economic activities, separate the world into an industrialized rich center and a de-industrialized poor periphery. Over time, falling trade costs and growing demand for manufacturers will make a new location outside the center competitive and prompt industries to locate there, bringing with them the benefits of agglomeration. By this model of development, the center expands to include more countries. But this is not an indefinite process, whereby low-income countries get absorbed into the ranks of the affluent; rather, it involves a rapid jump into the center by those countries for which such a jump is facilitated by geographic proximity (Nicholas Crafts & Anthony Venables, J.). Moreover, even assuming continued progress in the field of information technology and lowered costs for the transport of goods, it still seems highly likely that “economic

agglomeration” will continue to be a significant phenomenon. This is so for various reasons, including the complexity of information, the importance of communication to innovation and the demand of knowledge workers for the comforts of urban life.

Institutions and agglomeration are not mutually exclusive phenomena. Firstly, the very important notion of path dependence has a root in economies of agglomeration, which is a major element of economies of scale. Path dependence, which explains disparities in economic power among nations, is one of the key words in the literature of institutional economies. It is economies of scale that bring about this path dependence. Secondly, institutions and agglomeration either exist independently or, in most occasions, the occurrence of agglomeration may enhance the strength of institutions. Venture capitalists, who have a decisive impact on the creation and growth of business ventures, are said to exist in basically every agglomeration area. One possible reason for this, as one might expect, is that people present on the local scene tend to be most intimately familiar with the local situation. They know who the players are – such as the entrepreneurs, other venture capitalists, attorneys and accountants – and they are familiar with technology trends. In a place like Silicon Valley, where huge numbers of business ventures are created, personal reputation plays a big role in the decision-making process. In actual practice, of course, venture startups often amount to a hold-up no matter how closely the situation is monitored. Sometimes it is a matter of an entrepreneur accepting a huge capital contribution but then pursuing the venture in a lackadaisical manner, and it sometimes happens that venture capital is not used in the manner that investors had been led to expect. Venture capitalists may also have an incentive to cause problems by modifying their initial commitment, or perhaps by failing to provide an entrepreneur with sufficient compensation. Personal reputation, however, serves to mitigate this type of opportunism. Many things are known only to those actually on the scene. Geographic proximity to a given region is important to one’s ability to become familiar with personal reputations, and to update them as appropriate.

2. The Intended Message

The message of last year's *White Paper* was as follows: "East Asia is likely to continue developing. Whether or not that development poses a threat to Japan is entirely up to Japan. We should carry out reform in order to ensure our ability to achieve sustained innovation."

There was a strong tendency in Japan last year to view events in East Asia, and especially in China, as a threat, and to see Japan as facing a major problem caused by industrial hollowing out. While perhaps not going so far as to say that something must be done to prevent economic growth in China and elsewhere in East Asia, not a few people were certainly of the opinion that there was no need for Japan to encourage it. Last year's *White Paper* argued against this sort of view. In surveying the changing economic structure in Japan and the surrounding region, the *White Paper* noted a gradual shift of industrial agglomeration, from Japan's Pacific belt zone to its periphery, and from there to the rest of Asia. This shift has been underway since the 1970s, and recent developments in China and elsewhere can be simply reported as a continuation of the trend. The *White Paper* took the position that the development taking place in connection with this trend was a historic inevitability, and could not possibly be prevented. And even if Japan's trade surplus continues to shrink for many years into the future, last year's *White Paper* argued that this was simply another historical inevitability and should not be seen as a problem, for both the United Kingdom and the United States experienced the same thing as their economies reached maturity.

With regard to the issues that have been the focus of so much hand wringing and panic, our position was: "There is no point in raising such a big fuss, because this is all an inevitable by-product of growth. It would make more sense for us to take a fresh look at ourselves and work hard on our own behalf." We were prepared for heavy criticism from all directions, but the reaction from journalists was quite positive. Although editorials generally provided about eight parts praise to two parts criticism, some of them were entirely positive. Nevertheless, I did receive criticism from journalists who voiced concern about the

flagging state of Japanese industry and felt that the *White Paper* offered few substantive examples of successful activities.

With the above in mind, we have focused on three main points in this year's *White Paper*.

Firstly, we have sought to present a detailed picture, based on microdata, of the activities of Japanese corporations in East Asia. In addition to case studies focusing on individual companies, the *White Paper* also uses the results of surveys targeted at individual Japanese enterprises with overseas operations to analyze their investment activities. This analysis reveals that Japanese enterprises, in deciding where to locate their operations, no longer make any special distinction between domestic and overseas locations. As economic ties in East Asia grow closer, Japanese companies are taking an increasingly global perspective in making location decisions. The decision to locate overseas once entailed considerable risk, and any company choosing that route did so with an understanding that great difficulties might lie in store, but this distinction is disappearing. (Table 1)

Secondly, the message of last year's *White Paper*, as described above, was primarily domestic in focus, but this year's *White Paper* also addresses issues concerning the whole of Asia, such as policies regarding energy security and Asia bonds. In addition, this year's *White Paper* also deals with economic systems. Analyses of economic systems tend to be based primarily on an American model or, in other words, on an Anglo-Saxon way of thinking, but countries differ from one

another in actual fact. Excepting for accounting systems and other things that are generally uniform across national borders, each country has its own unique system, a message that this year's *White Paper* seeks to get across to an Asian audience.

What kind of changes will occur in national economic systems as the world economy undergoes globalization? One area where globalization will have the deepest impact is corporate systems – especially corporate governance – due to increasing cross-border capital flows and the growing freedom enjoyed by corporations in the location of their operations. Establishment of sound corporate governance is important if we are to proceed with the integration of a sound East Asian economy and attract a steady, dependable inflow of capital from outside the region.

A detailed analysis reveals considerable diversity in the economic systems of different countries, and in the measures being taken to achieve improvement. This variety manifests itself in many ways, including the following: (1) the level of development of individual countries; (2) the relationship between companies and the government (e.g. various approaches to the roles of rule maker and rule keeper – necessary elements for the existence of markets); (3) corporate financial structure, including funding procurement structure and shareholding structure; (4) management-labor relations; (5) the state of the market for top managerial talent; and (6) various approaches to corporate social responsibility (CSR). Despite the diversity, however, commonalities

Table 1 Views Regarding Locating Overseas

The *White Paper* uses two different models to analyze the question of whether companies feel that locating operations overseas is drastically different from locating in Japan, and in both cases the analysis indicated almost no difference. (There is almost no difference in validity between the two models in the table below.)

Indicators of model validity

	Distinction in domestic & overseas locations (2-step model)	No distinction in domestic & overseas locations (1-step model)
Indicator (1) (log likelihood)	-2,364	-2,369
Indicator (2) (AIC)	4,760	4,758

Notes: 1. We compared the validity of the following two models:

- (1) Does the company view locating overseas as something special, such that it decides first whether to locate overseas or domestically before selecting among actual locations? (2-step model)
Or...
- (2) Does the company view overseas and domestic locations as being the same in nature, such that it has only to select a location? (1-step model)

2. As explanatory variables, for both models we have used parent company sales figures, export ratios, labor cost ratios, personnel expense ratios, research and development expense ratios and host-country GDPs.

exist with respect to the general direction in which system improvement measures are headed. All countries, for example, hope to improve corporate governance by introducing checks and balances, and to that end are working to build the necessary mechanisms (e.g. sharing of needed information and disclosure of corporate information) upon which such checks and balances will rely. And all countries are working toward the goal of maximizing long-term corporate value to a wide variety of stakeholders. In recent years, moreover, we have seen intense discussion of the concept of CSR, whereby enterprises are called upon to move beyond the pursuit of short-term gains and pay attention to the environment, employment and other larger social values. Especially in Europe, moves to address CSR are being pursued not only in the private sector, but also at the European Union and national government level. This kind of idea is expected to attract more and more concern as time goes by in Japan and throughout the world.

Briefly reviewing the situation in a few selected countries, in the United Kingdom and the United States, where companies have always tended to rely primarily on direct financing, there have been moves to reform boards of directors, using outside directors as a means of maximizing shareholder value, while in recent years there has also been much discussion concerning the role of institutional investors who are major shareholders. In Germany, where indirect financing is more prevalent, the Hausbank has always played a role in monitoring corporate management, complemented by collective decision making (a unique aspect of German corporate culture whereby employees participate directly in company management), but there have been signs of change in recent years, including moves to introduce "shareholder value-oriented" managerial practices (i.e., practices intended to maximize shareholder value). In South Korea, reforms are currently in progress, especially with respect to the *chaebol* system, which in the wake of the Asian financial crisis has come to be regarded as the main drag on business efficiency in South Korea.

And thirdly, in writing this year's *White Paper* we have also sought to communicate the message that Japan is changing. The idea that Japan is not changing at all

enjoys considerable currency, as evidenced by how often people refer to Japan's the "lost decade." But a close look will reveal that change is indeed underway. A number of Japanese corporations are performing quite well throughout the entire East Asian region. And there are signs of inexorable change taking place in Japanese-style economic systems, which were once seen as the key to – and indeed, the very symbol of – Japan's success. COVER STORY 2 will examine this change in close detail.

The message of this year's *White Paper* can be briefly summed up as follows.

With regard to the basic approach to the task of improving economic systems, all countries are introducing checks and balances and working to improve information sharing. At the same time, however, different countries exhibit diversity, so it is not a matter of "everyone adopting a single, superior system." The task at hand is not simply to copy something, nor can anyone afford to say, "We're fine just exactly the way we are." Every country has to take a hard look at itself and find its own way forward. Japan must understand this fact and continue making an effort.

This said, Japan has not been sitting passively by. An intense, sustained effort is being made. Although people often speak of a "lost decade," a steady process of change is underway. This can be clearly seen in the strategic approach taken by the many Japanese corporations turning in stellar performances in East Asia, and it is also readily evident in the tremendous changes now taking place in the business climate in which Japanese corporations operate.

Japan will continue to work steadily on the issues facing the nation. Japan is open to the rest of the world, and as such will welcome outstanding managerial talent and human resources. At the same time, Japan will reform innovation systems, overhaul intellectual property strategy, and expand service sector activities. In addition, the nation will also exercise leadership through our strong efforts to address energy security, monetary and fiscal stability, and a range of other issues of regional concern in East Asia.

By taking the measures outlined above, Japan will strengthen its economic ties with the rest of East Asia and take a multi-tiered approach to its overseas economic policy.

In closing, although I do feel somewhat apprehensive about the future, I would like to address the reasons for hope. In last year's *White Paper*, we focused mainly on the domestic situation, while urging the Japanese people to work hard to better our situation and to re-establish our self-reliance. This year, in addition to that aspect, in writing about changes in Japan and the nation's efforts to address regional issues, we have addressed an audience of readers both in Japan and overseas.

In last year's conclusion, I stated as follows: "The fundamental source of anxiety is our lack of self-reliance. Japan has never closed its doors completely on outside cultures, technologies, or systems. On the contrary, we have always embraced outside influences, and over time, made them into something of our own. We haven't just copied or borrowed wholesale. Neither have we only rejected. Taking in, digesting and assimilating ideas from abroad has always been Japan's greatest strength. Now we seem to be losing this ability due to a lack of self-reliance and an apparent inability to think logically and make sound judgments."

A year later, that special strength of the Japanese people may yet be with us. In just one year, change has come to the fore. Or perhaps one could say that we are seeing signs of good things to come. Of course, the results thus far still leave much to be desired, and there is no consensus about whether we are moving to the right direction or not. And there is absolutely no justification for blind optimism among even the most inveterate of optimists. But we do have corporations that are performing extremely well, and it is a fact that change is occurring, brought on by Japanese people demanding a freer economic system. What kind of economy awaits us? Or perhaps one should ask: What kind of economy do we want?

We are no longer trying to catch up with developed countries, but are seeking our own path, onward and upward. We have already taken our first steps on the journey.

Our task is to continue the journey until we find what we seek. Needless to say, we are going to make sustained efforts to overcome the challenge. **JTI**