

The Keiretsu Advantage: How Japanese Automakers Thwarted American Competition

Jasper Boers¹

¹*Yale University*

Abstract

Today, Japan's auto industry is renowned for its dominance of foreign markets. Japanese cars are cheap and fuel-efficient, undercutting larger, more expensive automobiles from Europe and America. Scholarship on recent Japanese industrial development tends to prioritize a 'developmental state' and robust industrial policy in shielding Japanese manufacturers from trade liberalization. This paper will argue that, while the industrial policy steered by the Ministry of International Trade and Industry (MITI) played a significant role in advancing the interests of the Japanese auto industry, it was ultimately the unique trust-based keiretsu conglomerate structure that gave Japanese auto producers a comparative advantage vis-à-vis their American counterparts. Cost reduction on the firm level allowed major Japanese automotive companies to skirt free trade measures, simultaneously insulating their business model from the American led trend towards globalization and trouncing the American automakers, for whom union politics and steeper production costs encumbered coordinated and strategic growth.

INTRODUCTION

Through both the pre and post-war periods of Japan's history, industrial capacity was intimately linked with the country's national interest and identity. One integral component of that industrial capacity was Japan's automotive industry. The cars produced by the major Japanese automakers—Honda, Toyota, and Nissan—are today as ubiquitous as ever. However, the industry behind the disproportionate amount of cars imported from a tiny island nation in East Asia informs a broader narrative of US-Japan relations. The story of the rapid rise of Japan's automotive production demonstrates that economic attitudes among producers, rather than government planning, take precedence. How the major Japanese car brands crafted an industrial strategy to compete with and outpace America's deep manufacturing base is rooted as much in clever

engineering as it is in smart investments, trade, and management practices.

In this paper I will argue that the story of Japanese automotive dominance is only partly explained by Chalmers Johnson's theory of the "developmental state" and a robust industrial policy. Rather, Japan's bid for control of the global auto market was supported primarily by the keiretsu business structure which was designed to thwart foreign competition, especially from the United States, by keeping costs low and supply chains guarded. Moreover, I will explain the ineffective measures undertaken by the United States to combat the keiretsu in the 1995 Auto Dispute, demonstrating the failure of American economic policy to outcompete coordinated firm planning in Japan. The evolution of the shaky US-Japan

economic alliance throughout the post-war period, with a focus on the automotive industry, will reveal how Japan “won” the globalized auto trade during the 1990s and beyond, establishing themselves as the premier exporters to the United States of cheap, fuel efficient cars in the 21st century.

The rapid expansion of the Japanese auto industry in the post-war period challenged American automakers on two fronts: design and cost. Japanese cars were smaller and cheaper, designed better for the fuel-conscious urban consumers who began to make up a larger and larger share of the American market. Furthermore, the 1973 oil crisis sparked a general market trend which favored smaller, affordable cars, and American autos were large and fuel-inefficient, making them less attractive than their Japanese counterparts. But Japan was not only in the business of making the right car at the right time. The unique style of Japanese industrial organization—keiretsu—aimed at keeping prices down for Japanese producers while leveraging foreign markets as much as possible. Ultimately, it was these keiretsus that proved to be the determining force in the auto trade between the United States and Japan.

CHALMERS JOHNSON AND THE DEVELOPMENTAL STATE

In his book *MITI and the Japanese Miracle*, Chalmers Johnson argues that the key to Japan’s economic success lay in a strong industrial policy guided by state authority. MITI, the Ministry of International Trade and Industry, steered and coordinated the Japanese economy out of its post-war malaise. The policies it supported were guided by an economically nationalist creed; Johnson writes that MITI “is convinced that market forces alone will never produce the desired shifts ... of energy and resources into new industries and economic activities.” Under this broad philosophy, MITI policy

organized Japanese industry through patent regulation, trade barriers, and technology transfer restrictions. All of these policies can be labeled under the banner of “industrial policy,” a phenomenon that economist Robert B. Reich has described as a policy that “focuses on the most productive pattern of investment, and thus it favors business segments that promise to be strong international competitors while helping to develop the industrial infrastructure (highways, ports, sewers) and skilled work force needed to support those segments.” MITI, according to Johnson, was merely the next stage of evolution for Japan’s prewar controlled economy. While Japanese government ministries before and during the war mobilized domestic industry to produce defense technology and wartime materiel, the post-war attitude focused on dominance in the expanding semiconductor and auto industries. Like before, Japan endeavored to use targeted industrial policy to decouple its economic power from constraints on its geography and natural resources. Unlike before, the main exponent of Japanese industrial policy—MITI—would harness and redirect globalization and trade liberalization rather than aim at pure autarky.

Thus, Johnson seeks to prove that there exist sizable “differences between the course of development of a particular industry without government policies ... and its course of development with the aid of governmental policies.” Johnson’s thesis may not be wrong—industrial policy certainly contributed to the global ascent of Japanese industry in the latter half of the 20th century. However, his framing of Japanese industrial policies ignores some of the key non-governmental factors—like the infamous keiretsu structure, which exacerbated trade tensions between the United States and Japan by protecting the auto industry. In light of the oil crisis, low prices appear to have been the central ingredient of successful carmaking, and keiretsus allowed for major automakers with extensive supplier networks to slash production costs through

lower wages and higher quantity production. An analysis of the late history of the auto industry in Japan will, I hope, augment Johnson's thesis and explain why internal microeconomic aspects of firm organization ultimately guided the success of the Japanese auto industry. As we will see, even the neoliberal agenda of President Clinton proved insufficient in breaking the backs of the keiretsu.

JAPANESE INDUSTRIAL STRATEGY IN THE POST-WAR PERIOD

Prior to World War II, Japanese industrial capacity was packaged into zaibatsu—monopolistic and oftentimes dynastic corporate entities which controlled entire industries. The zaibatsu organized themselves around “holding companies, interlocking directorships, and mutual stockholdings,” as well as “Extremely large financial power in the form of commercial bank credit.” This organizational structure likely gave Japan an advantage in wartime, as their industrial capacity was retooled for military hardware and industry entered an autarkic phase. Moreover, the enmeshed zaibatsu acted as their own support system, with each of the three major zaibatsu families—Mitsubishi, Sumitomo, Mitsui, and Yasuda—owning a significant percentage of the banks of the other zaibatsu. In the aftermath of the war, the zaibatsu drew the ire of American bureaucrats and military officials like Major General William Marquat, who broke up the zaibatsu in order to achieve

“economic deconcentration,” a policy which aimed at preventing Japan from being able to leverage a deep industrial base to pursue future military objectives. The initial American

antagonism towards Japan's proprietary style of industrial organization would persist, just like the overall organization of the zaibatsu themselves. SCAP policy, although successful in eliminating much of the crony dynasticism of the major zaibatsu, did not rid the Japanese economy of the structural blueprint created by the zaibatsu. Rather than disappear, the basic groupings of companies beneath umbrella holding companies that characterized the prewar zaibatsu survived into the postwar period, with each of the major Japanese automotive companies retaining the linkages of its respective zaibatsu network.

In fact, the zaibatsu groupings remained largely intact, renewed by

re-investment in the same type of interlocking stockholding arrangements which connected the prewar monopolies, albeit without the aegis of a large bank to provide liquidity to the affiliate zaibatsu companies. The keiretsu which emerged in the aftermath of the American occupation bore many of the same features of their zaibatsu predecessors. They were networks of similar firms linked by similar interests in keeping the prices of auto parts down and keeping exports boosted. The Japanese auto industry, once woven into the zaibatsu system, was in the postwar period organized into vertical keiretsu. These arrangements aimed at controlling the supply chain of manufacturing for a given good—automobiles in this case—in order to internalize input costs and achieve a close level of

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cooperation which could outcompete foreign automakers. As opposed to the prewar zaibatsus, the keiretsus were not organized centrally by a family-owned banking trust. Rather, they were vertically or horizontally integrated supply chains which fostered close cooperation between keiretsu members in order to cut costs and reduce competition for inputs in order to strategize years into the future. Gone was the characteristic zaibatsu family structure, which was viewed by General MacArthur's economic advisors as an autarkic obstacle to a democratic Japanese political economy.

In the post-war keiretsus, the linkages between a primary auto manufacturing firm, like Toyota, Honda, or Nissan, and their subsidiary auto parts and affiliate firms were governed primarily by a mutual goal of maximizing economic production. In the automotive industry, cost reduction on a per-firm basis of even the smallest percentage can yield large savings and higher profitability when extrapolated to the entire industry. Moreover, in the resource intensive car industry, the central nodes of the keiretsus—the automakers themselves—could dominate the network, demanding cost cutting from their affiliates in return for the promise of greater bulk orders and business aid to the smaller firms. The stability of this keiretsu system in the automotive industry “increases the self-sufficiency of the keiretsu and promotes long-term cooperation through mutual sustenance.” The mutual dependencies created by the keiretsu networks among Japanese automakers and part suppliers allowed for a unique bargaining environment which gave Japan an advantage over the auto industry in the United States: cheaper car production.

KEIRETSU ORGANIZATION: A FIRM LEVEL VIEW

The strength of the keiretsus lay in the advantages they conferred to their members. In many ways, the keiretsu was a

distinctly Japanese phenomenon—the culmination of a tradition of Japanese industrial discipline and strategy begun in the Meiji Restoration.

From the view of an American firm, each of the major Japanese automakers—Honda, Toyota, Nissan, and Mitsubishi—maintained their own keiretsu. With the exception of Mitsubishi, which can be classified as a horizontal keiretsu due to its involvement in multiple industries in addition to auto manufacturing, the auto conglomerates each organized their own, distinct supply chains. This system reduced competition between automakers and siloed production via interlocking shareholding agreements and long term contracts between suppliers and automakers. To an extent, the auto industry in Japan was anti-competitive vis-à-vis foreign firms. However, Japanese automakers, aided by MITI's protectionist policy still competed against one another on the issue of engineering and design to capture the global market. The industry was not a cartel, so much as it was a highly coordinated oligopoly. Without the influence of MITI, the automobile industry in Japan could not have enjoyed such high levels of success abroad. Without the keiretsus, they could not have sustained growth and production on the global scale.

Keiretsus were bonded together by creating economies of scale for all members of the conglomerate and by reducing production costs for those members. One of the largest sources of cost-reduction for the large producer firms was in wages—in 1960, wages at smaller subcontracting firms were 60% of the larger firms which they supplied. Low wages were reinforced by the Japanese tradition of lifetime employment, which made suppliers reluctant to hiring new employees, instead waiting to phase out a generation of workers. Keeping labor entrenched in the keiretsu system resulted in cost savings on all levels. These features made the relationship particularly advantageous to a company like Toyota or Nissan, for whom lower domestic input

costs increased competitiveness on the international market. Moreover, smaller firms were rewarded for their willingness to supply inputs at a lower cost with larger purchase orders. The inter-firm relationships established in the keiretsu structure limited the flexibility of smaller firms and enhanced the profitability of larger firms.

Why did American firms not emulate their Japanese competitors? The reason is primarily cultural: Japanese automakers maintained a high degree of trust with their supplier firms, while American automakers kept suppliers at arms-length. Interlocking shareholding agreements and consulting and business assistance followed purchase orders. On average, Japanese automaker-supplier relationships had endured for an average of more than 40 years by the turn of the 21st century. Established, institutional trust was a hallmark concept of the Japanese keiretsus, and one which was completely foreign to American automakers. The story of the keiretsu, therefore, is a story of American industrial sclerosis and Japanese industrial innovation.

ADVANTAGES OF KEIRETSU MEMBERSHIP

Keiretsu membership was an appealing proposition for member firms for many reasons, but the most important were the following: the potential for a robust supplier-producer relationship in which suppliers oftentimes advised or invested in their supplier affiliates, and the economic protection offered by a larger firm with production capacity around the globe.

At Toyota, keiretsu negotiations between auto executives and suppliers were conducted in large conference rooms known as obeyas. The primary function of these rooms was to facilitate cooperation and information sharing between all sectors—supply, design, engineering, and finance—integral

to the automotive development process. These types of meetings, in which suppliers were directly involved in the design process, were a unique feature of Toyota's corporate style. They allowed the affiliate firms of Toyota's keiretsu to participate directly in product-development meetings, thus expediting the time it would take to design and produce a car and fostering closer interpersonal relationships between producer and supplier. As is apparent from the name, the obeya were an explicitly Japanese phenomenon, originating from the Toyota Motor Corporation. While American firms would later adapt to the Japanese style of auto manufacturing, the obeya strengthened the keiretsus and simplified Toyota's car development timeline. And obeyas were not an isolated aspect of the keiretsu system. Rather, they were part and parcel of a broader network effect of the keiretsus that allowed the member firms to outcompete their foreign competitors by making cheaper cars in higher volumes, leveraging close, trust-built relationships to streamline production.

Automotive keiretsus were also bonded together by a system of "mutual sustenance" that ensured that the business success of the central carmaker would trickle down to the parts suppliers. Honda would routinely offer advice and business support to its suppliers, helping improve their profitability and in turn securing the relationship for Honda's future production needs. This facet of the keiretsu structure was grounded upon the principle that investing in the member firms would translate to long term growth investment in the larger automakers. Rather than laid out in a contract, the resulting relationship which developed between the affiliates and their keiretsu partners was one "based on trust, cooperation, and educational support for suppliers." The stability which this model afforded to all participants far outweighed the potential downsides of such coordination, allowing all firms to engage in economies of scale in a less competitive business environment.

Overall, the keiretsu corporate structure gave the Japanese auto industry the microeconomic flexibility to make

larger investments in international growth. Within the keiretsus, profit incentives for both automakers and their suppliers enjoyed a direct relationship. In the United States, however, such buyer-seller networks simply did not exist. On top of that, the trust-based relationships upon which the keiretsus operated also made outside suppliers and producers less appealing to keiretsu member firms, creating a sort of trade barrier independent of government intervention. That trade barrier was strengthened as much by the guarantee of economies of scale as by a recognition that all Japanese firms would act cohesively. Keiretsu member firms with long term contracts to the central automaker would rather continue their bilateral relationship with that firm than sell to a foreign automaker, with whom they would not have had the advantage of a shared culture or national interest. That exclusivity, and the commercial security it afforded, undoubtedly shaped the impenetrability of the keiretsus to American competitors. While Japan's keiretsus were at their height, foreign competitors could not leverage trust-based relationships with producers to keep prices down and make long term investments. Given the international circumstances of the 1973 oil crisis, the internal management of auto firms mattered substantially more on a basis of cost savings, far more than MITI's capacity to restrict or subsidize trade and industry.

THE AMERICAN RESPONSE TO JAPANESE INCURSION

The background of the keiretsu industrial structure in Japan provides ample contrast with the automotive industry in the United States. While major Japanese auto manufacturers leveraged their industrial organization in order to cut costs, shield their domestic market from foreign competition, and flood the international marketplace with cheap cars, American automakers lacked the adaptability and flexibility to compete

with an industry that was so internally coordinated. Japanese trade representative Hidetoshi Ukawa stated in an interview that “we [the Japanese] can't dictate the size of our [auto] exports to the U.S. market. That depends on the American consumer.” This attitude towards the auto trade reflected in Japan an understanding mirrored by the keiretsu arrangements—that under the pressures of trade liberalization and globalization, cost-reduction and industrial coordination would yield marketplace dominance in the vital auto industry. Cheaper production costs stemming from low wages met demand for cheaper cars, and Japan was able to make those cheaper cars, largely independent of MITI policy.

American demand for Japanese cars was so high in the early 1980's, that, in 1985, MITI announced the continuation of a Voluntary Restraint Agreement to limit the amount of auto exports Japan shipped to the United States. The 1985 VRA had been in place several years prior and responded to the concerns of the US automakers, who believed Japan was becoming a hegemonic force in the automotive industry: between 1969 and 1985 Japan increased its share of global car production from 3.6% to 25.5%. But instead of catching up to the Japanese industry, the Americans stagnated. Economics reporter Hobart Rowen wrote in *The Washington Post* that, “the American industry did almost nothing to make itself competitive with producers of small Japanese cars. The VRA never was linked to specific investment decisions or wage concessions.” In other words, the American automakers did little to recalibrate their investments in relation to Japanese market expansion.

While the American auto industry continued to putter along, producing large, fuel inefficient cars, the Japanese built up their portfolio of factories in the United States, continuing to poach business even under the VRA. By subverting the VRA and relocating a share of production to the U.S. mainland, the Japanese auto industry, independent of MITI's direction, improved its condition. The VRA merely served as a signal to redirect investment to cope with the pressures of trade

liberalization. And voluntary agreements could only go so far towards securing a future for US automakers—in the wake of the VRA, Toyota, Honda, Nissan, and Mitsubishi all made investments in US plants and negotiated to supply US automakers with engine parts and in some cases even whole cars to fill the subcompact range. The major Japanese firms also entered into “joint-venture” agreements with their American counterparts, agreeing to supply US automakers with parts, and in some cases even mass purchase orders for finished autos. American firms ultimately found it more profitable to enter contractual agreements with larger Japanese firms. Japanese producers were simply better equipped with their keiretsu cost savings to dominate the global market for small cars. Under the VRA, which was official MITI policy, the Japanese automakers adjusted short term investments in ways which would serve their long term export ambitions and corner American automakers on their home field.

On the American front, the development of auto manufacturing had been enjoying steady growth since the beginning of the postwar period. That growth among the Big Three automakers—Chrysler, Ford, and General Motors—however, was halted by the oil crisis, and between 1972 and 1980 imports of cars, mostly from Japan, grew from 15 to 27 percent. In the preceding years, stability in the auto industry had handed the United Auto Workers a considerable amount of political power, forcing wages for auto workers up and thus squeezing the auto industry’s ability to respond to changing consumer demand. Thus a void was opened and promptly filled by small Japanese cars. Unlike in the United States, Japanese auto worker unions, like the Toyota Motor Workers Union, were more or less subservient to the corporation whose employees they represented. This symbiotic relationship contrasted heavily with the large concessions demanded by UAW representatives of the Big Three. A 1998 UAW led strike on General Motors contributed to a daily loss of \$80 million dollars. Such strikes were nonexistent in the factories of

Japanese automakers, on the Japanese mainland or in the US, where the Japanese sought to avoid the management problem of unionization. Therefore, the issue of unions, although isolated internally within the domestic politics of Japan and the US, had an external effect on the balance of trade between the two countries. Overall, industrial organization and management-level decision making can reflect massive differences in profitability and market share in the auto industry. While the Japanese utilized keiretsus to cut costs and pursued a policy of non-unionization in the United States to keep wages down, American manufacturers could not match the pricing nor possessed the business flexibility to meet changing consumer demand.

THE 1995 AUTO DISPUTE: KEIRETSUS IN DIPLOMACY

The tensions from the era of the VRA continued into the 1990’s, proving that the auto trade surplus which Japan enjoyed with the United States was relatively immune to trade restrictions. These tensions between the United States and Japan came to a fore in the 1995 auto dispute, in which President Clinton threatened to enact \$6 billion in tariffs on luxury auto imports to the US from Japan in response to Japanese unwillingness to make room for American auto part imports in Japan. The lesson of the dispute, and its recognition of the increasingly globalized supremacy of the Japanese auto industry, speaks to the potency of Japan’s keiretsus to delay and avoid trade liberalization.

The dispute, which arose out of a complaint launched against Japan by the United States and the WTO, reflected American exasperation with Japan’s growing automotive power. While Japanese companies continued to undercut American competitors by using the unique structure of the keiretsus to avert steep supply costs, this strategy also limited

the power of American companies to export to Japan. This imbalance produced a Japanese auto parts market of which Americans made up 2.6%, and an American market of which the Japanese made up 32.5%. Under the agreement, the American threat of sanctions brought the Japanese to concede non-specific import quotas. While the official terms of the agreement seemed to benefit both sides—Japan avoiding costly tariffs and the United States’ suppliers gaining a foothold in the seemingly impenetrable Japanese market, the lack of concrete steps to address the trade imbalance was flagrant. For one, the keiretsus of the auto industry openly opposed the import quotas, as ceding a portion of their supplier network to foreign competition would undoubtedly hurt their bottom line. As a result, there were no concrete quotas enacted under the agreement, as Japanese industry had the final say, thus exposing the discrepancy between the perceived power of MITI to put Japanese industries in line and the relative independence of the auto industry on matters of trade. Americans recognized this issue, and the New York Times reported that “the issue [of the auto dispute] was considered critical to breaking the “keiretsu” system of suppliers, which [had] been blamed for many of the troubles American companies encounter in Japan.” Just a few years before the dispute erupted, Japan’s trade surplus with the United States also became a point of contention for third party presidential candidate Ross Perot, who often remarked on the declining caliber of US auto manufacturing and the necessity of bolstering domestic production with industrial policy. Overall, the trade dispute points to the fact that the CEOs of Japan’s automakers would eventually determine the success of the agreement, dictating to the American their adjustments to import buying, not vice-versa. The survival of the profitable keiretsus, rather than MITI’s policy, once again seemed to directly affect Japan’s global automotive reach.

CONCLUSION

A Harvard Business School Report on the “new keiretsus” asserts that “the essence of keiretsu has proved durable, and the ability to avoid the hidden costs of Western-style supplier relationships is an important reason.” The keiretsu structure has largely survived, despite the recent global movement towards market liberalization, led often by the United States. The fact that keiretsus have seemed to be so impenetrable in the auto industry is largely a testament to their ability to coexist with, adapt to, and sometimes even determine the course of state policy and diplomatic agreements. The 1985 VRA extension and the 1995 auto dispute both allowed the auto industry to utilize their efficient keiretsu business structure to work around political conditions which were hostile to the growing Japanese trade surplus. In each case, it was the keiretsu which offered the Japanese auto industry a competitive advantage, allowing them to cut costs and reshuffle investments to box out foreign competition. It is this story then, in addition to the story that Chalmers Johnson tells in *MITI and the Japanese Miracle*, which explains the rapid ascent of Japanese auto manufacturing in the postwar era.

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