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Special Essay:

Japan and the Global Factory

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Buckley & Strange (2015) have highlighted the major changes in the global location of economic activity over the past 30 years, with the emerging economies assuming greater shares relative to the advanced economies. They noted that the major drivers of these changes included inter alia economic restructuring and market liberalization in many countries in Asia, Eastern Europe and elsewhere; financial deregulation and the integration of world financial markets; trade and investment liberalization (including the proliferation of multilateral and bilateral preferential trading arrangements); and technological advances, particularly in information and communication technologies (ICT) and transportation/logistics. The associated international fragmentation of value chains has also increased the importance of intermediate goods trade in the global economy. Trade in intermediate goods now dominates global trade flows, accounting for over 60 percent of world exports, although this overall figure masks marked differences between countries and between products (UNCTAD 2013: 122).

The shifts in the global location of economic activity have been significant, and have excited much interest both in the academic literature and inpolicy circles. These shifts have led many commentators to refer to the idea of the **global factory**, but in several ways. Gereffi (1989) used the term global factory to represent “the emergence of a global manufacturing system in which production capacity is dispersed to an unprecedented number of developing as well as industrialized countries”. The greater dispersion of activity had been associated with a widening of corporate ownership on a global scale, with many more firms controlled by a more diverse set of owners in many different countries. In contrast, Grunwald & Flamm (1985) conceived of the global factory as the result of the growth of foreign assembly facilities, and highlighted the fact that many MNEs from advanced economies had undertaken foreign direct investment (FDI) and established offshore assembly operations to meet the competition of low-cost imports. Many value chain activities had been relocated to emerging economies, but these activities were still integrated (internalised) under common ownership within MNEs headquartered in advanced economies notwithstanding their geographic dispersion. Clearly Japanese MNEs have been a major part of this story, especially considering the flows of Japanese FDI to South-east Asia over the past three decades.

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A third possibility is that this offshoring of activities has been accompanied by an outsourcing (externalization) of some of the value chain activities to independent suppliers (Buckley & Ghauri, 2004). Outsourcing involves the lead firm externalising stages of its value chain and involves an organisational fragmentation of production, whilst offshoring refers to the relocation of production overseas and involves an international fragmentation of production. Outsourcing and offshoring are conceptually different, and have different determinants. Outsourced activities may take place within the same country, or involve the relocation of production overseas. Offshored activities may take place under the control of the lead firm (FDI), or independently. Outsourcing involves not only a physical 'slicing-up' of the value chain, but also a change in its ownership. Here the global factory is seen as a complex strategy by the MNEs to reduce location and transaction costs, with global value chains linked together by international flows of intermediate products. Importantly, the lead firms are assumed still to control the resultant distributed networks of activities even though they have relinquished equity ownership.

Now there is a substantial literature on the activities of MNEs from advanced economies (including Japan) and, more recently, MNEs from emerging economies, and much extant theorising about the motives for FDI. In contrast, theoretical explanations for the growth in outsourcing relationships are less persuasive (Strange, 2011). One popular explanation suggests that lead firms engage in outsourcing because they wish to focus on their core competencies. A second explanation highlights internal deficiencies, and suggests that outsourcing allows the lead firm to complement its own scarce resources and capabilities with those owned by the external suppliers. A third explanation is that external suppliers may be able to secure advantages in terms of innovation and cost savings because they are able to specialize in production. A common feature of these explanations is that outsourcing is the preferred organizational form for many lead firms because external suppliers are somehow able to provide the requisite goods and services at lower cost than the firm is able to do internally - i.e. it is more efficient to externalize than to internalize production. The arguments have merit as explanations for the growth of outsourcing of IT and other support activities, but they have less convincing as explanations for the growth in outsourcing of primary activities (e.g. manufacturing). Yet many firms in many industries have outsourced key manufacturing activities to independent suppliers: well-known examples include Apple and Nike. The lead firms in all these cases have chosen to externalize various primary activities even though it appears unlikely that there are efficiency gains from using external suppliers. This is true both when the outsourced activities are undertaken within the home country of the lead firms, and when they are also offshored.

An alternative explanation for outsourcing emphasizes the asymmetric power relationships between lead firms and their suppliers, and argues that outsourcing takes place when lead firms have the ability to leverage their power in value chains to extract higher profits (Strange, 2011). ICT advances have reduced the costs of searching for potential suppliers by lead firms, and increased competition between suppliers at various stages of the value chains. This has shifted power within value chains away from suppliers towards the lead firms, who are able to control the interface with the final customers through a variety of isolating mechanisms (Rumelt, 1984; 1987) such as formal property rights, technical knowledge, branding and other marketing capabilities, and first-mover advantages (Lawson et al, 2012). Firms that control these interfaces with the final customer are able to relinquish ownership and externalise the production of various intermediate goods and/or services within their value chains, whilst crucially still retaining effective control over the chains.

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But the efficacy of many isolating mechanisms will tend to dissipate over time as competitors emerge to imitate successful strategies and products, and as resource and capability asymmetries erode. Furthermore, the very act of contracting an outsourcing relationship undermines the power asymmetries between the lead firm and its supplier, and increases the lead firm's dependence upon the supplier. Suppliers may also upgrade their positions within value chains, and develop their own distinctive resources and capabilities. There is thus an inherent dynamic to the outsourcing relationship, and the relationship will tend towards balance unless the lead firm is able to maintain its isolating mechanisms and to counteract this tendency towards over-reliance on its supplier by only forming short-term contractual relations. Many authors have pointed to the high rates of instability in outsourcing arrangements, although the reasons and implications of this instability have yet to be satisfactorily investigated.

Abundant data are available from public sources on FDI flows, but comprehensive empirical data on the scale of global outsourcing activities are difficult to find. UNCTAD (2011: 132-3) estimate that cross-border manufacturing outsourcing amounted to about $1100-1300 billion worldwide in 2010. Data by industry (UNCTAD 2011: 135) shows that many of the most active sectors are related to some of the most strategic sectors in Japan, such as electronics (with $240bn of cross-border outsourced sales, and 1.7m employees), auto components ($220bn sales, 1.4m employees), garments and apparel ($200bn sales, 7m employees), and pharmaceuticals ($30bn sales, 0.2m employees). Furthermore, there is little or no empirical information focusing on the evolving power relationships and dynamics of outsourcing relationships (though see Denicolai et al, 2015 for an analysis of the relationship between Apple and the Foxconn Technology Group).

"Japan is a particularly good empirical context in which to explore empirically these theoretical ideas given the widespread use of outsourcing relationships in manufacturing industry."

Japan is a particularly good empirical context in which to explore empirically these theoretical ideas given the widespread use of outsourcing relationships in manufacturing industry. In their survey of 5528 Japanese manufacturing firms (out of 14,062 firms with more than 50 employees), Ito et al (2007) reported that 3391 firms (61.3%) were outsourcing to domestic suppliers and 1136 firms (20.6%) were outsourcing to overseas suppliers in 2006. Over 55% of the domestic outsourcing involved the production of intermediate or final goods, whilst this figure was over 70% for offshore outsourcing. Furthermore, Ito et al (2007: 9) note that the extent of outsourcing had increased over the five years from 2001, and that “more and more firms are engaged in outsourcing to suppliers in the same country and in procurement from foreign sources, but the growth of offshore outsourcing clearly outpaced these two modes.” My guess is that the extent of outsourcing will have increased still further by 2015, and I conclude by suggesting that a research project involving both the collection of up-to-date information on outsourcing in Japanese manufacturing industry and some detailed longitudinal case studies exploring the dynamics of the relationships between the lead firms and their suppliers would be timely.

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Special Essay:

Kojima Theory VS Reading School - Retrospective and today significance of 1980's controversy

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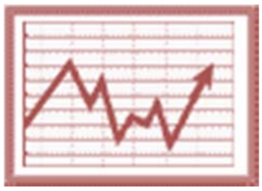
Introduction

The so-called "Kojima theory" which had been formed gradually from the 1970s to the mid 80s, in the research field of MNEs and FDI, has had a significant impact in Japan. Kojima tried to integrate the international trade and FDI by the same principle of comparative production costs, as a macro economic theory. He also contemplated to allow the effects analysis of economic welfare to both investment countries and host countries. It is an achievement that can be called a monumental work in Japan. As well, it is thought to have been a big contribution in the world of main international economics.



On the other hand, the "Reading School" was raised in the United Kingdom at the almost same time. This school was formed a so-called "Internalization Theory" as the core of international business literature, by paying attention to the micro phenomena of international companies' operations. It highlighted the "internal transactions of companies" than "market transactions" with uncertainty. In the field of international business, it has been internationally regarded as the dominant theory to explain behavior of MNEs.

"In this essay, about the 80's controversy, we will clarify the issue, and consider the subsequent academic development and contemporary significance."

The two different academic tidal currents intersected each other in the 1980s, when Buckley and Rugman who were powerful members of Reading School introduced the "Kojima Theory". Kojima regarded an "Internalization" as the theory to justify monopoly or oligopoly by MNEs from the point of view of the international division of labor. In this essay, about the 80's controversy, we will clarify the issue, and consider the subsequent academic development and contemporary significance.

Assertion by Kojima

The Reading School that had been formed in England in about the same time along with Kojima theory from the 1970s, exchanged several papers with each other in the 1980s, which led to the deployment of their theory. At the time, Kojima considered trying to build the "integration theory of international trade and FDI", and it was necessary to subsume the macro-economic approach and the International Management Approach (International Business). On the other hand, the focus of the Reading School

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was "Internalization" which focused on investment of companies in overseas subsidiaries. According to Kojima (1984a), a feature of International Management Approach that is representative in Reading School was as follows.

IB approach emphasizes special factors of companies, such as intangible capital, ownership advantage, and management assets. Companies make their organization and activities multinational in order to save a variety of transaction costs such as transport expense, selling expenses, and information cost. Thus "internalization" is achieved in the company. The concept of these IB approach, can be a powerful description principle of MNEs, and Kojima (1984b) was evaluating it. But, the IB approach was too much grounded in business factors. As a result, the works of the Reading School were not considered at all. This point was felt as the major problem for Kojima. On the other hand, Kojima being from the field of international economics had recognized there were problems with this approach. Traditional trade theory of international economics ignored all transaction costs such as transport costs and advocated that the direction of trade should be guided by the principle of comparative production costs. Kojima thus set up to address the weakness.

Until 70s, Kojima theory was appropriate to be called "macro-economic theory of FDI". Thereafter he had actively incorporated micro factors of companies. This is a constructive criticism of the Reading School, so that those toward a new horizon of international economics could appreciate its significance. In fact, Kojima (1984) built-in micro companies' variable such as transaction costs (T) and company' capacity (E), which was the emphasis of Reading School. However, the task of integrating the "macro-economic theory" and "corporate behavior of micro" was rather difficult, and we cannot overlook that a big gap in the basic point of view existed between Kojima and Reading.

Kojima's macroeconomic approach dwelled on the benefit of trade to the national economy, and not profit maximization in companies and what would be the most suitable action by the individual company. What he wanted to contemplate was how an optimal allocation of endowment resources could take place was, within the framework of an open national economy. This was supposed to contribute to increase of national welfare, and set the development direction of the national economy, as well as maximize the economic welfare of partner countries. In contrast, the IB approach pursued how profits of individual companies could increase, and how market share could expand. The critique of Kojima thus uncovered that IB theory had ignored the perspective of optimal allocation of resources, and maximization of economic welfare of the national economy.

Kojima dismissed Dunning's (1980) theory because arguing it was impossible to theorize the many factors that extend to a total of 32 listed as "eclectic theory". In addition, Kojima criticized the OLI triad itself.

First, the OLI paradigm was a company point of view of all micro factors that total upto 32 and it completely ignored the national economic general equilibrium and national economic welfare. Furthermore, by highlighting the advantage of the use of the internal market in companies as a response to a defect in the market, the OLI ignored the inevitable defect of monopoly. This was unacceptable to Kojima. Secondly, in the IB approach, FDI is deemed because the MNEs has excellent ability than other foreign companies in the same industry, therefore MNEs is able to obtain the benefits of internalization, and at the same time it can obtain locational advantages to use inexpensive resources. Kojima pointed out that "Internalization" and "Locational advantages" are unclear. Third, Kojima argued that the IB approach is intended to justify, the overseas expansion of the international production and sales activities from the point of view of private corporate profits, exports, and technology. It does not mention at all the benefits of host country. Kojima have claimed, FDI must be elucidated from macro-economic point on the issue of national economic welfare and development promotion of the host country. And, companies' ability (E) model he adopted has been the position of the macro-economic approach. The above is the issue of the Reading School by Kojima.

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Assertion by Reading

Rugman (1981) from Reading School first criticized Kojima theory. Rugman argues the premise of Kojima model is different from the reality. His claims are as follows.

Kojima model is based on the world of competitive market and the Heckscher - Ohlin model. Products are always assumed to be homogeneous products, and it was a mistake to ignore the dynamic nature of the technology cycle. Kojima argues that FDI from the US based on the premise of comparative advantage in the US is trade destructive.

However, contrary to the claims of Kojima, Rugman mentions that most FDI from the US is not trade destructive. According to Rugman, FDI is an alternative to free trade as there was a need to exercise control over information used, and for MNEs to reap the private reward of knowledge creation investment. For MNEs, FDI could avoid the dissipation risk of its technical knowledge. When exports are obstructed by the barriers, such as tariffs, FDI replaces exports. Thus FDI is rather a trade substitute than trade destructive in Rugman. So, internal control is a matter of necessity for companies in order to avoid "Dispersion risk of the technical knowledge" according to Rugman. In addition, as a means to avoid trade barriers, MNEs would prefer in some cases FDI. We can think that "FDI of reverse trade" in Kojima as "FDI of trade substitute" in Rugman.

Today, taking the cue of Kojima we might regard the claim of Rugman as a "justification of private interests". Buckley (1983) asked, what's the Kojima theory? According to him, Kojima theory should be labelled by words such as "macro-economic approach," "factor endowments approach," "forward trade type FDI", "Japanese-style FDI". Buckley says what is the most appropriate theory amongst these is not clear. Buckley (1985) then pointed there are some common matches in research methods between Reading School and Kojima theory.

1) The importance of locational factors, the concept of "factor endowments" are the same in both.
2) With respect to entry modes, both approaches emphasized the push not only of "export" and "FDI", but also other modes the "licensing" and "general trading company".
3) Insofar as the relationship between FDI and economic welfare, Reading also admitted a close importance. For example, Buckley himself cites, as a "problem of internalization", benefits of entry barriers and vertical integration, such as a company within the cartel by bid-rigging. "Justification of monopoly" which Kojima pointed out, is never in Reading.
4) As an approach of minimization of "transaction cost" (T) which Kojima is attempting, his model itself resembles the Reading technique that incorporates an "internal market" and the "external market".
5) Kojima points out institutional factors of nation, for example, the consent of the government, procurement of raw materials, tax incentives, deregulation, wage levels, are also included in Reading approach.
6) The same principle applies to the market creation function as raison d'etre of MNEs.
7) With respect to the study of a general trading company (Sogo-Shosha) by Kojima and Ozawa (1984b/d), their claims of "new form" is "false economies of scale" to pursue private interests, while reducing the trade cost. Buckley argues that in Japan which has the background of a relatively underdeveloped capital market, general trading companies have emerged to use internal capital markets. In contrast, the organization of information available in the same "confidential way" in the West is performed by multinational banks.

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In general, it can be said that the criticism of Kojima by Buckley is piecemeal.

Today's significance

As it is well-known, in "International Economics", the integrity of the theory is very important. On the other hand, in the "International Business theory", company behaviors apparently depict the real picture.

Is it possible that academic dialogue can draw from an intersection of both streams?

About the future of international business approach, how was Kojima thinking? The advocacy of Kojima was as follows. According to Kojima (1984), he predicted that IB approach would be remaining relevant only in case studies. Because too many ownership advantages exist, for example the number of transportation means and routes, tariff rates, transaction costs, ways of sale etc., IB approach would not be possible to construct a theory. Is this prophecy correct when viewed from today? Since the encounter of Kojima theory and Reading School in the 1980s, international economics and international business have separated from each other without much convergence. For the side of the IB approach, general theory of MNEs including the interests of the international division of labor and the national economy cannot be said to have been admitted. However, discussion of internalization and monopoly by huge companies that Kojima was concerned with since the 1990s, seems to have been overcome by the recognition of the new realities as "strategic alliance" , "outsourcing" and "downsizing". Today, there have been many discussions by huge companies. They are lots of topics, such as "the external market and internal market segregation", "selection and concentration by MNEs", "internationalization by small and medium-sized companies ", "cyber companies by IT", and " Born Global Companies". These studies may somewhat reassure Kojima. Thus "international Business" and "international economics" is studying the same phenomenon of MNEs and FDI. If we lose the opportunity to learn sincerely from each other, it is really unfortunate. The experience and time that existed in between Kojima and Reading in the 1980s is a great event to be noted for us today.

"Thus 'international Business' and 'international economics' is studying the same phenomenon of MNEs and FDI."

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