Conclusion

This year’s White Paper on International Trade follows last year’s trend of allocating a great deal of space to descriptions of the East Asian economy and Japan. Having had the good fortune to be responsible for writing the White Paper for two consecutive years, I would like to take this opportunity to provide some explanatory notes.

The first explanation that should be provided concerns the perspective and technical tools applied in analysis.

This edition refers mainly to “institutions” related to economics. Chapters and sections that bear no relation to institutions are rare in the White Paper on International Trade 2003. In particular, the following sections discuss formal and informal aspects of various institutions: Chapter 1, Section 3: “Changes in the corporate economic system—diversity of corporate institutions and commonalities in efforts to implement improvement;” Chapter 3: “Efforts toward the vitalization of the Japanese economy;” and Chapter 4: “Issues and challenges for Japan’s external economic policy.”

Although the importance of institutions was reflected upon and institutions were frequently mentioned in the previous edition, the White Paper on International Trade 2002’s main angle for analysis was “agglomerations.” In particular, Chapter 1, Section 2: “Japan’s changing local economic structure and competition and partnership with East Asian economic agglomerations,” and Chapter 4, Section 3: “Formation of attractive economic agglomerations,” contained analysis focusing on the key word “agglomerations.”

Institutions and agglomerations are both extremely important concepts in relation to economic growth, as explained below. They also have one point in common. That is, both system analysis and new spatial economics that deal with agglomerations focus on events that are classified as derivate phenomena in typical neoclassical theories, or that would not fall into their scope of analysis in the first place, such as strategic behavior, asymmetric information, economies of scale (in the broad sense), externality, path dependency, lock-in, and self-organization.

Nobody would dispute that economic growth is one of the most important objectives of economic policy. The following is a more detailed explanation of the relationship between economic growth and “institutions” and “agglomerations.” (See diagram below).
Economic growth is defined by, among other things, material capital formation, human capital formation and the creation of innovation. Put another way, economic growth is determined by the amounts and types of capital and labor that are invested, and how they are utilized for production and innovation. Thus, in discussing economic growth, there is a need to examine this entire process. Further, it should be noted that in this analysis the objective of economic growth does not equate with the maximization of GDP or GNP, nor is so-called “economic growth supremacy” advocated. It is completely natural to also think of values that cannot be measured by GDP, etc., as objectives of economic policy. Additionally, even if we limit our outlook to economic growth itself, the questions of what to assume as the objective of economic growth and how to measure it should be decided by the people. It is possible, and indeed desirable, to have a scheme wherein issues that are not at all easy to quantify, such as quality of life, are taken into account when policy choices are prepared and decision-making carried out. The point here is only that no matter what kind of economic society one visualizes, the issues of investment of capital and labor resources, as well as innovation, are of extreme importance. That is to say, while the objective of economic policy is improving the welfare of citizens and residents, it will be primarily dependent on resource investment and productivity, no matter how that improvement may be defined.

Returning to the main topic, in the above process, the decision on capital and labor investment is directly linked to the question of how these resources should be allocated.¹

Generally, there are thought to be two methods of allocation of resources. One is through the market, the other through the organization. In the market, as the result of competition among transacting entities, resource allocation is determined by price. With an organization, of which the company is a typical example, resource allocation is determined by authority.  

¹ The phrase “what types of capital and labor” includes the aspect of improving capital and labor quality (accumulation). Institutions play a large role in efficient allocation of production resources as well as in improving quality of production resources (accumulation of knowledge capital). The external effect of agglomerations also affects quality of capital and labor.
Economic growth is determined by the combination of production and creative innovation brought about by utilizing allocated capital and labor. In recent years, the great influence of institutions on this overall process has come to be actively recognized. Economic historians, particularly in the context of the history of the new institutional economy, stress the impact of the attraction mechanism between investment and innovation, and argue that economic disparity is brought about by path dependency on systemic rules. For example, according to North, the system is the rules of the game, which come in two forms, official and unofficial. The former includes the general legal institutions (tariffs, various investment-related institutions, contract law), and fundamental laws of the state (e.g., constitution). The latter refers to conventional practices, and is sometime expressed in terms such as “cultural” and “endemic.” The former are explicit and thus can be newly implemented, but if the latter remain the way they have been, the implemented (official) institutions cannot function. There is a wide range of subjects of system analysis that deal with a broad range of subjects including the assignment of private property rights, services related to enactment and formulation of legislation, fund supply mechanisms, R&D mechanisms, the labor market, and business practices, but it is safe to say that the institutions provide a common understanding of how the game is played for each player, organization and individual.

The discussion on such institutions is also very lively in relation to East Asia. Researchers, typified by Aoki, are yielding a great deal of knowledge on Japan and East Asia.

When thinking of economic growth and innovation, another perspective that is just as important as that of institutions is the standpoint of the new economic geography that emphasizes increasing returns. Changes in transport cost in the broad sense (distance-related cost) and economies of scale affect each other, and as a result, new industrial and economic maps emerge. Economic agglomerations are organizations and individuals gathered together (although there is the issue of whether to include corporations envisioned as the atoms of a perfectly competitive market in the category of organization). What, specifically, are the dynamics that drive economic activities to concentrate geographically?

A general idea that is common through the results of research in new spatial economics, is that agglomerations are formed through the interaction of economies of scale, cost of goods transport and diversity of goods and people in the production of goods and services. First, economies of scale means economic efficiency in relation to production factors, in the sense that production capacity increases as industries and corporations grow in scale, and can also be thought of as decreasing costs. However, in the formation of agglomerations, it is thought that the economies of scale generated from various “externalities” are playing a more important role. Alfred Marshall, who is renowned for this theory of “external economy,” cites external economic factors that bring on agglomerations: (i) pool of laborers with specialized skills created through geographic concentration of a single industry; (ii) formation of a specialization network by specialized corporations; and (iii) ease of innovation attained through the geographic concentration of related...
industries. Relationships between corporations and industries emphasized in Marshall’s external economies are easy to understand when seen in terms of forward linkage effect and backward linkage effect. That is, when one industry agglomerates, specialized corporations that produce various intermediate input goods gather, creating a specialization network (backward linkage effect). This boosts the productivity of the industry using the intermediate input goods, thus attracting more companies belonging to that industry (forward linkage effect), completing a virtuous cycle. The situation is the same when one looks at labor instead of intermediate input goods. Next, “transport cost” needs to be seen as not only transport costs in their narrow sense, namely the expense of moving goods over distances, but also as including distribution costs and the costs incurred by the movement of persons and information and tariffs associated with imports and ease of market access, which are transport cost in a broader sense. If transport costs are very high the movement of goods is difficult. Therefore it is better for each area to produce the goods that it consumes; agglomerations or geographically concentrated production do not occur, and economic activities thus remain dispersed and isolated. On the other hand, if transport costs are extremely low, physical distance presents no problem, it therefore does not matter where companies locate, and the resulting establishment of companies tends to be scattered. However, in cases where transport costs are in the mid-range, there is a high possibility that agglomerations will appear. In this way a certain degree of transport cost seems to play a role in the formation of agglomerations. With regard to the third factor regarding profit from diversity in goods and people, there seems to be a tendency that consumers who desire diversity concentrate in urban areas, and corporations in cities that are home to many consumers. Though the formation of an agglomeration is often triggered by the market transaction of goods, external economies arising from human, non-market interaction play an important part in the development of agglomerations, be it in cities or in areas where a particular industry has been traditionally strong. As both Marshall and Saxenian emphasize, in the formation of regional agglomerations and innovation of a particular industry, face-to-face communication plays an important role and external economies based upon human diversity are highly relevant. In recent economic growth theory (endogenous economic growth theory), a spillover effect that is brought about by knowledge stock in the R&D sector is garnering attention, and in the field of spatial economics too, analysis focusing on the agglomeration of intellectual activities is being vigorously undertaken. It should also be pointed out that as IT continues to develop, and the transport cost of goods drops steadily, it is difficult to deny that economic agglomerations will continue to play a major role in relation to innovation, considering the realities that information is complex and that there is much creative benefit in face-to-face communication, and that knowledge workers will always seek a better living environment.

One outcome of the agglomerations is that, as it exercises its effect through mutually connected economic activities, it divides the world into two spheres – one that is rich and industrialized, the other that is poor and unindustrialized – even if there was originally no difference in institutions or

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economic policy between the two. Over time, surrounding areas begin to benefit from the agglomeration as well, gaining competitiveness as various mechanisms – lowered transaction costs and a rising demand for manufacturing, for example – start to work, causing further agglomeration in these areas. The result is that, following the original agglomeration, more and more areas and/or countries will develop because of their relation to the central, already agglomerated area. However, this is not a universal process by which poorer countries become rich. On the contrary, the process is one whereby some countries, which through geographical proximity have easy access to central areas, can make a rapid transition from poor country to rich country. This is interesting when one considers the contrast between the post-war development of East Asia and the recent stagnation in Africa, in particular the sub-Saharan countries.

Both institutions and agglomerations share the fact that they clarify the importance of phenomena that have often been overlooked by the neo-classical school of economists. The two are in fact closely interrelated.

For example, one of the main concepts of institutions analysis, is that it is “path dependency” – in which even minor institutions differences in the course of time lead to considerable gaps – that brings about economic disparity. One of the main causes of path dependency is increasing returns, and one of the major factors affecting the base of increasing returns is the “agglomeration economy.” Hence institutions and agglomerations are closely interrelated by nature.

In addition, these two often complement each other. In fact, there are many cases in which “agglomeration” seems to reinforce the power of “institutions.” Venture capitalists have a decisive impact on the birth and growth of venture businesses, and it is said that, as a general rule, one venture capitalist is active in an area in which there is agglomeration. One of the reasons for this may be the effect of familiarity with the area. That goes for information about the players – such as entrepreneurs, other venture capitalists, lawyers and accountants – as well as about technology and other trends. In addition, in areas such as Silicon Valley in which many venture businesses appear, the reputation of the parties involved plays a large role in decision-making. In fact in the course of starting up a new business, even exhaustive monitoring cannot always prevent a situation where things are going nowhere. For example, an entrepreneur who has received a large sum of money from the investor may not work seriously or may use such money for other objectives. The venture capitalist may have a reason not to keep the initial agreement and not provide the entrepreneur with sufficient funds. What prevents such opportunistic behavior is reputation. There are many things that one can learn through being close to the place where events are occurring, so it appears that the creation and revision of reputation is heavily influenced by the parties involved being geographically concentrated.

There are other factors as well. Suppose there are two areas in which there has not been any difference in institutions or other conditions, but through agglomerations or otherwise, great differences have appeared in economic activity. It is easy to imagine large differences in the status of institutions and their effectiveness (assignment of private property rights, formulation of laws and services related to their enforcement, fund supply mechanisms, R&D mechanisms, labor market, commercial practices, etc.). These differences in institutions bring about the drive to
agglomerate, which in turn creates further differences in institutions, and so the circle continues. One example of note would be the development of Silicon Valley and the downturn in the relative standing of electronics industry agglomerations in Japan. The truth is, when analyzing an area in terms of institutions and agglomeration, one very often comes to realize that the two points of view are really considering the same elements. Some universities are actively engaged in R&D activities with external partners, a flexible fund supply mechanism, and a flexible and capable labor market, for example. All these can be referred to as “excellent institutions” or, alternatively, the same situation can be described as “various entities that undertake these activities have agglomerated in that area.” However, while institutions analysis looks mainly at the incentive schemes as offered to various entities including both individuals and organizations (companies, universities, government, etc.) and the balance brought about by their strategic behavior and its standardization, the interest of the new spatial economic analysis of agglomerations lies with the spatial aspects arising from the driving force to agglomerate (this force can be negative, in which case it works against agglomeration) brought about by various entities and by parameters such as transport costs in their broad sense. This means that when analyzing multiple areas, the two approaches differ in the following way. Institutions analysis compares the institutions of one area with another (depth of economic agglomerations, etc.). New special economic analysis, on the other hand, is a dynamic analysis applied to institutions, and to changing aspects in each area at different stages, taking each area’s institutions at a given stage only as a precondition and naturally keeping in mind that they change according to the level of agglomeration.

The second explanation regards the message of the White Paper.

Our message last year was that, “East Asia has already been successfully industrialized, and looking at the long-term history of the world economy, the region’s development is set to continue. Whether this will present a threat or opportunity for Japan depends entirely on Japan, so we must carry out reforms in order to ensure the sustainable outpouring of innovation in Japan.” The fact is, last year the atmosphere in Japan was one that tended to view the trends in East Asia and China in particular as a threat and there were several viewpoints that regarded hollowing out as a major problem. In response to this, the White Paper last year noted that, “looking at the changes in the regional economic structure in Japan, it would appear that economic agglomerations have moved from the Pacific belt zone to the periphery of Japan. In addition, the path for this trend started prior to the 1970s, and spread to the whole of Asia. It is based on the understanding that recently this trend is merely only continuing to progress, now including China.” It also pointed out that even if the trade surplus of Japan were to decrease over the long-term, this would be a phenomenon akin to the prior experiences of the UK and US accompanied by the maturing of their economies, and was something that should be considered in terms of an historic flow. With regard to the various controversial issues in the world, in response to the assertion that “there are unavoidable aspects that arise concomitant with growth,” it was emphasized that “instead of unnecessarily perceiving problems, now should be the time to take a good look at ourselves and make efforts to create agglomerations that will foment innovation.” In saying this we were prepared for criticism from
various parties, but in the end we feel that, generally, our statements have been received favorably. That is not to say that there have been no critics; we have heard remarks reminding us that, considering the difficulty that our country is facing such as the weariness in non-central regions, perhaps there should have been more concrete suggestions as to what to do in the future.

With this in mind, we have applied the following changes and modifications to this year’s White Paper.

First, we have grasped Japanese corporate activities in East Asia in detail, based on microeconomic data and specific cases. Specifically, analysis was conducted on investment behavior by Japanese companies, using individual data on those companies which are operating overseas. As a result, with the increasing closeness of economic relations in East Asia, the choice of location for Japanese companies has expanded in step with globalization trends. Overseas location has now come to be undifferentiated from domestic location. In addition, case studies of each individual company demonstrate that many Japanese companies are succeeding in gaining profits, through strategic efforts such as creating new demand through differentiation and constructing an optimal production and specialization structure with East Asia. What many of these companies share in common is the wish to grasp business opportunities provided by the expanding East Asian economy, and the aggressive efforts towards the creation of a management structure that will actively make the most new demand and cost competitiveness.

The second point is that in contrast to last year’s message which, as already mentioned, was by and large directed to the domestic market, this year we have taken up not only issues for Japan but also those for the whole of Asia. For example, with regard to such issues as energy security and Asian bonds, these are raised this year as issues related to Japan’s external policy. Japan will not merely stick only to issues that pertain to it alone, but will continue to demonstrate leadership in issues that face the entire region.

Third, there is great diversity in both the current status of corporate economic institutions and improvement measures in each country. While it can be considered that such diversity reflects the differences in the varying circumstances in each country, at the same time it shows that there are some commonalities in the direction of system improvements. Efforts toward improvement in corporate governance through ensuring mutual supervision, and improvement in basic mechanisms to that end (sharing necessary information and disclosure of corporate information) are common to all countries, and each country is making efforts to improve corporate institutions with the aim of maximizing long-term corporate value based on the perspectives of various stakeholders. However, to repeat, diversity among the institutions of each country remains as before.

The fourth point we hope to communicate is that Japan is changing. So often we hear the phrase the “lost decade” and how Japan has not changed, but looking closely, one realizes that changes have become apparent. One example of this is the “strategic efforts by Japanese companies in the East Asian region” and another is “changes in the corporate economic system of Japanese companies.” There are now a number of robust Japanese companies that are operating in East Asia with the entire region as their playing field. In addition, the Japanese economic system, regarded to be the factor behind Japan’s success, is showing clear signs of steady change. Gradual
changes are being witnessed in all aspects, from corporate ownership, structure and the relationship between companies and banks to the relationship between companies and workers. These facts show clearly that changes are occurring in Japanese corporate strategy and the Japanese economic system.

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.

This concludes the explanatory notes to this year’s publication and in concluding the White Paper for this year it should be said that while there are still some uncertainties that cannot be glibly wiped away, some expectations can be made. While last year’s publication was a message that called for autonomy and inspiration exclusively in the domestic situation, this year’s edition adds elements that convey to people at home and abroad the changes in Japan and the content of Japan’s efforts and measures to deal with regional challenges.

The following was stated in last year’s conclusion. “The fundamental source of anxiety is our lack of self-reliance. Japan has never closed its doors completely on outside cultures, technologies, or institutions. 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.”

While it is the case that one year has passed since those words were written, they remain pertinent today. It could also well be said that in the fleeting space of one year, changes in Japan
have been remarkable and that optimism has come to pervade. Certainly it cannot be said that the results of the previous return have been stunning, and neither has consensus been reached even on whether the changes have been in an entirely positive direction. Above all, we are definitely not yet in a situation when even the most extreme optimist can simply be happy. However, extremely robust companies still exist and further changes are occurring that have been demanded by Japanese people to create a freer economic system. What economic society lies in store for us? Or should the question rather be phrased, what kind of economic society should we seek?

Our task is not to chase other developed countries, but to stay firm and true in our search for a silver lining to the clouds that are scudding by. Our journey along that road has already begun.

Our challenge is to link this search to palpable and abundant benefits. Needless to say, we will continue to pursue this challenge relentlessly.