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LONDON SW1A 2AA

From the Private Secretary

19 November 1986

Dear Mike,

PRIME MINISTER'S MEETING WITH THE PRESIDENT OF THE KEIDANREN

The Prime Minister saw the President of the Keidanren for a talk this afternoon. Mr. Saito was accompanied by the Japanese Ambassador. The Trade and Industry Secretary was also present.

The Prime Minister welcomed Mr. Saito, recalling with pleasure her meeting with the Keidanren during an earlier visit to Japan. She believed that Britain had a great deal to learn from the Japanese manufacturing industry. We had great respect for Mr. Nakasone. The Economic Summit in Tokyo had been very successful.

Mr. Saito recalled that he had recently seen Prince Hiro who had spoken warmly of his experiences in Britain. Mr. Saito continued that he had had a good discussion with Mr. Channon earlier in the day on the difficult question of Japanese trade imbalance. There was no need, in his view, to revert to this subject. (Some hope: Ed!). He regarded his meeting with the Prime Minister as a symbol of the close relationship between the United Kingdom and Japan.

The Prime Minister thought that Mr. Saito might find it instructive to have a first-hand account of her views on the trade imbalance. Time after time, at Economic Summits and in bilateral meetings, we were assured by Japanese Government representatives at every level that action would be taken to deal with the imbalance. What happened in practice was that it just got worse. Either the promised action was not taken or the expected results did not come through. It was no good thinking that the trade imbalance could be resolved by taking 4 per cent off the tariff on chocolate. We needed some large orders, such as Airbus. Moreover, despite all assurances, various artificial barriers and restrictive practices continued. The problem of whisky and other alcoholic drinks was a particularly glaring example, which had led the European Community to resort to action under GATT Article XXIII. There were also the well known examples of seatbelts and skis. Mr. Saito should take back home the message that Europe was very restless about the imbalance and no-one more restless than she was.

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Mr. Saito said that he did not want to go into details. He had heard the story about the skis in every European capital he had visited. We should give more credit to the action of the Japanese Government in allowing the Yen to appreciate. This had had a tremendous adverse impact on Japanese manufacturing industry. The number of bankruptcies had risen steeply and unemployemnt was also increasing. Nonetheless, he appreciated the strength of the Prime Minister's feelings. He drew the conclusion that Japan's efforts to deal with the trade imbalance had not been sufficient.

The Prime Minister said that we very much welcomed Japanese investment in the United Kingdom. She was certain that the new Nissan plant would be a great success. Japanese companies which invested in Britain found that the productivity and efficiency of British workers, when allied with Japanese style management, was as good as those in Japan. Mr. Saito should tell his Keidanren colleagues that Japanese investment here was very welcome.

The Prime Minister expressed concern that one of the results of the recent United States Congressional elections would be increased pressure for protectionist measures. This had been evident even in the closing stages of the last Congress, which had taken measures which would hit our exports to the Community of some £250 million in a full year. That apart, she thought that the economic prospects were good. The United Kingdom was looking for further growth next year. She was reasonably optimistic about the world economic situation. Mr. Saito said that he was pessimistic about the situation in Japan. Growth would be less than 3 per cent this year and next. He believed that the Yen was now too high. His former company, Nippon Steel, would lose 100 billion Yen this year. There was no longer the feeling in Japan that the economy was strong and vital.

The Prime Minister referred to the problems for both Japan and Britain from the NICs and cited in particular South Korea's performance in steel and shipbuilding. Mr. Saito agreed that Japan was finding competition from these countries in her export markets increasingly difficult to meet.

The Prime Minister asked Mr. Saito to convey her regards to Mr. Nakasone and to the members of the Keidanren.

I am copying this letter to Alex Allan (H M Treasury) and Robert Culshaw (Foreign Office).

Yours sincerely,

Charles Powell

C D POWELL

Michael Gilbertson, Esq.,
Department of Trade and Industry

David Norgrove NBM

In view of the debate about Japanese shareholdings, the PM may care to see the attached FT article

George Guise

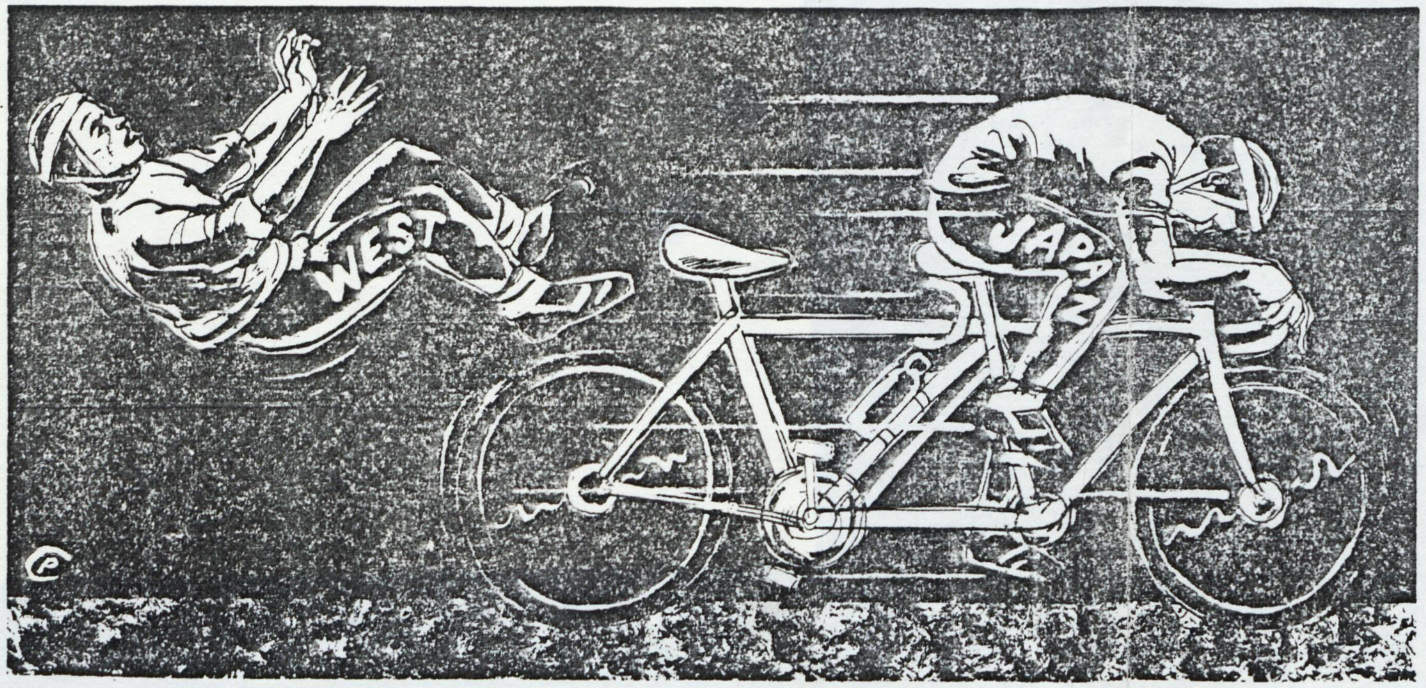
MANAGEMENT

EDITED BY CHRISTOPHER LORENZ

'Triad Power'

How Japan can put a spoke in the wheels of the West

Christopher Lorenz explains why collaboration can rebound



LIKE MOST of its competitors, and much of western industry these days, one of Europe's leading technology-based manufacturers has a collaborative agreement with a fast-rising Japanese company. In theory, the deal extends only to the exchange of technology.

Yet until recently the European company has been blithely introducing prime customers to its Japanese partner. Officially, the purpose has been to show them the latest Japanese products. But the European top management has just realised that the meetings have also given the Japanese precious knowledge about the European marketplace, right down to the detailed demands of individual customers. The policy is now under urgent review.

The situation epitomises the way that Japanese companies see their growing plethora of partnerships with western companies not as a cessation of past hostilities, but as a new—and highly lethal—form of competition.

According to the newly-fashionable gospel of global partnerships between Japanese, US and European companies, a new era of interdependence and power-sharing is emerging. Neither the Japanese nor the western company can succeed on its own, runs the argument. So both must collaborate, to their mutual and long-lasting benefit.

Not so, warns a group of leading US and European academics: that view may be shared by a large number of top US and European companies, but it is dangerously naïve.

Instead, the academics argue that the flood of international joint ventures and "strategic partnerships" merely represents a new phase in the vicious competition between Far East and West. It is a phase in which the Japanese are building ever more managerial and technological competence, while western companies surrender ever more control over their competitiveness.

Partnerships are just one more step in a strategy of global dominance by leading Japanese companies, Professor Yves Doz of Insead, the Paris-based business school, told a major international conference in Singapore this week. "Contrary to what some would like to believe, the multiplication of partnerships does not correspond to a genuine change in the logic of Japanese firms, from competition to collaborative strategies."

Doz's paper, on "International Strategic Partnerships—Success or Surrender?", was written jointly with Gary Hamel of the London Business School and Professor C. K. Prahalad of the University of Michigan. The three have been collaborating on an extensive study of global competitiveness over the past few years.

The paper was one of the most controversial contributions to the Strategic Management Society's annual conference, at which 400 managers, consultants and academics met to debate a wide range of issues, from corporate culture to the impact of information technology (see right).

The essence of the Doz-Hamel-Prahalad case is that the ultimate aim of most Japanese companies in their partnerships with the west is not to co-exist, but to extract their partner's core of skills, and then either disarm him into an ever-growing spiral of dependence, or break loose and compete with him directly. Their argument is in stark contrast with the "Triad Power" doctrine formulated, to widespread acclamation in the book of that name by Kenichi Ohmae, head of McKinsey and Co's operations in Tokyo.

The three academics insist that there is nothing anti-Japanese about their argument—it is just that the Japanese are better than the West, for a host of reasons, at exploiting partnerships to their own advantage. Most western companies have an awful lot to learn, they warn. They certainly have plenty of tips for them.

Citing a host of examples from a wide range of industries, the trio argues that "the partner intent on global leadership" (which in practice almost always means the Japanese) usually tries to annexe the other partner's skills, and to gain control over its technology, in order "to relegate the other partner to mere product distribution and the provision of less-than-critical contributions."

Among instances where this has already occurred, the academics cite NEC, which has transformed itself from "a rather hapless licencee" of Honeywell in the 1960s to being in a position to join Bull of France in effectively taking control of Honeywell's $2bn worldwide computer business; plans for the deal were announced last month.

Another case of the stronger partner annexing its "ally's" distinctive competence, say the trio, is the collaboration between Honda and BL (now Rover). In the words of their Singapore paper, "Honda made no bones about its desire to learn from Rover aspects of the design of large up-market sedans (saloons), a market segment in which it was not present and lacked experience. Similarly Komatsu relied on its agreements with Cummins to learn about the technology of diesel engines."

Even when the western partner is itself trying to play the same game, the academics argue that the Japanese still hold the whip hand. In its partnership with JVC and Thorn-EMI to make video cassette recorders (known as "J2T"), the French company Thomson has ambitions to learn from JVC's product engineering and manufacturing skills, in order then to re-assert its independence.

Yet Doz, Hamel and Prahalad report that JVC has erected a multitude of barriers against this eventuality. "JVC has constantly accelerated the pace of new product development, of improved product manufactureability, of transitions to new product generations (that is to "slim line" VCRs), so its partners constantly have to catch up, retool, gear up for new types, reinvest in manufacturing, and —given the smaller volume they make jointly for Europe, compared with JVC's own Far East production—incur permanently higher unit costs than JVC despite formidable efforts at cost reduction."

Thomson and Thorn-EMI also develop new VCRs on their own, "but they can only develop very few types, while JVC introduces whole new product generations at short intervals. As a result, the European partners are constantly running to catch up . . . . "

This is only one of many types of competiitve advantage which Japanese companies enjoy in partnerships with the West, according to Doz, Hamel and Prahaland. Another is the way the Japanese use evolving —not static—networks of partnerships, both to build their own skills and competitiveness, and to fight "proxy battles" against global leaders such as IBM. A Western company that sees its Japanese link in isolation from all the others, and considers its own relationship immutable, does itself a dangerous disservice.

In the computer industry, both Fujitsu and NEC have gained immeasurable competitive advantage from a welter of partnerships in complementary technologies and geographic markets. Fujitsu's partners, for instance, include Texas Instruments, GTE, ICL, Amdahl, Siemens and Telefonica of Spain.

In the European market, the local partners of both Fujitsu and NEC "have become the front line of the Japanese manufacturers' challenge against IBM," report the academics. So long as the local companies were relatively weak, IBM tolerated them. But now it has grown more aggressive. "Through this process, the (European) partners have become cannon fodder in a global fight, and may, ultimately, be worse off than they would have been before the partnership."

Yet another, but less obvious source of advantage to most Japanese companies in partnership with the West is the greater ability of their organisations to learn from their partners. This results in part from Japan's long tradition of selective absorption and adaptation of foreign ideas and technology, and also from the quality of vertical and horizontal communication in Japanese companies.

By contrast, as Doz and co point out, western companies tend to suffer from the notorious "not invented here" syndrome. And their greater specialisation of task and responsibilities makes the assimilation and use of complex know-how more difficult.

Even less clear to the inexperienced western eye is the fact that information exchanged between the partners, or gained by one of them, outside the formal areas of collaboration is just as important as what is traded within it. Much of the encroachment within any partnership, and the process of "dynamic bargaining" which accompanies it, occurs well down the organisation, out of sight of top management.

Western managers need to become much more aware of this problem, advise the academics. They must recognise where to draw the line, even if this involves aggravating their all-important Japanese partner.

The trio's extensive advice to western companies includes the following points:

● Partnerships are a second-best solution to going-it-alone. They are certainly fashionable, but they should be entered into only if really necessary, and then with great care. Significantly, the Japanese are proving most reluctant to co-operate with Korean electronics companies, who are using a succession of separate partnerships of limited duration—in an evolving network—as successive rungs on the ladder to international competitiveness. The Japanese are rightly reluctant, say the academics. By contrast, "US companies are helping Korean firms elbow onto the world electronics markets in the 1980s, as they did for Japanese competitors in the 1960s and 1970s."

● Encroachment can be contained in several ways, mainly by reducing the visibility and transferability of one's own contribution to the partnership. Partnerships in the aerospace industry, for instance, have resorted to very tight control of technology transfers. This includes the "triadic" partnership between Pratt and Whitney, Rolls Royce and a Japanese consortium for the development of the V2500 jet engine. But the academics are concerned about this venture on other grounds, including the advantage Japan may gain by having some of the same companies collaborate with Boeing on a different project.

● Western partners must constantly replenish their own core skills (such as product development and distribution networks), so that they can increase their bargaining power within the relationship, or their strength outside it.

Above all, Doz, Hamel and Prahalad warn that "the management of relative power within a strategic relationship is a fundamental and often neglected issue that companies approach piecemeal. As a result, many companies may lose more than they gain through partnerships, and may only become aware of this imbalance too late."

By then, they have no option left except to continue a relationship in which they are increasingly dominated. The fate has already befallen many well-known western companies. Hundreds more will follow unless they realise that (in the academics' restrained and elegant phrasing), a simplistic and naive view of the merits of "triadic" partnerships "can be quite detrimental to the long-term success of American and European firms." Put more succinctly, it can kill them.