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The Fall of Boeing and Japan's Airline Industry

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by Tanaka Sakai

What is the future of the competition to control the market in commercial aircraft between Boeing and the European Airbus? Does Japan have a role to play in the new generation of aircraft? While Boeing dominated commercial aircraft sales through the 1980s, in the 1990s it has fallen behind Airbus. As Tanaka Sakai shows, the stakes for the U.S., Europe and Japan are high, and the outcomes may deeply affect the ability of Japan and Asia to emerge as a major industrial powerhouse in the decades ahead. Tanaka Sakai, an investigative reporter, publishes the Japanese language weblog http://www.tanakanews.com. His report on Boeing and Japan appeared in the December 31, 2003 issue of Tanakanews. Developments since the publication of this article suggest that Boeing, and the Boeing-Japanese connection are central to a new lease on life for the beleagured company and industry. As the April 18 Asahi Shimbun reported,, Boeing announced the sale of 50 7E7s to Japan's ANA, valuing the sale at $6 billion and giving the airline confidence in moving the plane into production. Of particular interest is the fine print: Three Japanese enterprises, Mitsubishi, Kawasaki and Fuji Heavy Industries will provide 35% of the production of the new plane, centered on the construction of the wings, as well as providing a heavy share of the financing. Is this the way forward for Japan's lagging aircraft industry, or does it seal anew Japanese dependence on American aircraft production, with the U.S. maintaining monopoly control over the engine production? Tanaka suggests another possible scenario: Japanese-Chinese-Korean cooperation at the center of a future Asian regional design. But such a possibility will require major developments within Asian regionalism.

The mythical status of "maker" surrounds Boeing. The company represents American entrepreneurship in a way that compares with Sony and Honda in Japan. In 1966, during the directors' meeting to decide whether to develop the 500-seat class 747 jumbo jet, the head of marketing was asked about the size of investment required. He retorted that this problem paled compared to creating a large-sized passenger airplane. The development plan was approved.

When pilot-turned-designer William Boeing founded the company in 1916 his aim was to turn out the world's most advanced aircraft, and the mantra of profits coming second cemented Boeing's myth as "maker." When they placed their bets on the 747, the idea of airlines as a popular form of travel had not yet come into existence, nor had foreign tourism as an activity for the general public. The growth of airlines as a fiscally feasible concept was as yet untested, but by the 1970's airline travel had become the public's main choice and the price of tickets had dropped. The 747 was largely responsible for this development. Boeing's dominance in this sector of the industry continued as no other craft of comparable size was introduced and they continued to sell at a huge profit without having to reduce the price, in all selling about 1,400 airplanes.

Less Airbus's Success Than Boeing's Fall

However, the saga of Boeing as an American success symbol is beginning to come to an end. One reason is its displacement by the European maker Airbus. Until the 1990s it straggled behind the American maker, but in 1999 476 orders for the Airbus exceeded the 391 for Boeing craft, and the situation remained unchanged in 2003 (by the end of November: 263 orders for Airbus vs. 229 for Boeing). Times have changed since 1995 when Boeing controlled over 80% of market share. By October, 2003 estimated Airbus orders were worth $28.2 billion, while Boeing netted less than half of that at $11.1 billion.

Neither technical expertise nor the introduction of new concepts has been the cause of Boeing's loss to Airbus. Rather, the European maker has triumphed because Boeing made a grave miscalculation and discarded the "maker" philosophy. Since the introduction in 1994 of the 777, ten years passed without the introduction of a new line, and the R&D simply focused on modifications. In the two years that Airbus was marketing several classes of craft -- the A320, A330, A340, and A380 -- Boeing only sold its small-sized 150-seat 737. The current currency exchange rate of a cheap dollar vs. a strong Euro should have worked to Boeing's advantage, but it did not.

"Diversifying Operations"

Since around 1995 the American economy has been marked by an increasing wariness both in the market and among stockholders. For stockholders, the risks of overlooking profits in favor of the traditional production ethic must have seemed very great indeed. Therefore, a new style of management was inaugurated with the hiring of Phillip Condit as Boeing CEO in 1996 (he resigned on 1 December, 2003 over a scandal involving a deal with the military).

His idea was to earmark for development only those airplanes certain to sell, and only enter into a market that was guaranteed to turn a profit. Therefore, he refused to allow the development of two models that as yet had not elicited a response from the airline industry: the "sonic cruiser" high-speed passenger jet, and a greatly improved 747X meant to challenge the Airbus A380. Instead, Boeing sought to "diversify". In 1996 the company bought McDonnell-Douglas in order to enter the military aircraft sector. It also began venturing into the satellite business and acquired "Digital Cinema" that produces and distributes movies made with satellite photography. In the civilian aircraft sector that was its main business, Boeing adopted the policy of increasing sales by combining with the finance industry. They "created demand" by lending money to airlines so that they would buy planes.

In fact, airbus, too, created demand with the use of finance. But Airbus considered financing a money-losing operation. Although they sold passenger planes by lending money to airlines that were short of funds, they invariably tried to resell those bonds, watching the resale market and choosing times carefully to avoid losses. By contrast, Boeing separated its financial sector, making Boeing Capital (BCC), an independent financing company altogether. It aimed to generate profit not only in the sale of passenger planes but in finance, too..

Investors Not Risking New Development

The true differences in strategy of the two companies came to light after the 9-11 attacks when the US airlines industry was faced with a dramatic decline in customers and the industry as a whole was in financial difficulty. Although the BCC group was saddled with debt from bad loans, they believed the market would turn itself around in the short-term and increased their lending from $2.6 billion in 2000 to $12.5 billion in 2002. However, about 40 percent, or $4.7 billion of these loans, proved to be non-repayable.

Finally, in November of 2003 BCC's lending activities were halted, but the bad-load burden was only one problem: Airbus had also developed a new line of craft. There were no orders for the Boeing 757 in 2002 and only seven the next year, halting production. Orders for the 767 were paltry as well -- eight in '02 and eleven in '03 -- but when re-designed for military use as an airborne refueling vessel, one hundred orders were secured from the US Air Force. However, such were the accusations of corrupt practices in this deal that CEO Condit was forced to resign in scandal.

Adding to the financial woes, the satellite cinema distribution system was not paying off and had to be sold at a significant loss. In addition to shrinking profits in the satellite launching area, the military contract and much good faith were lost when the company was accused of stealing secret information about an observation satellite deal between the military and Boeing's main rival Lockheed-Martin. Boeing found itself in the red during the second quarter of 2003 (although other defense work enabled it to operate in the black by the third quarter). Boeing had to sell new models in order to rebuild its passenger jet arm. There were plans afoot to develop a mid-sized 200-seat class 7E7 but investors refused to endorse this project due to fears that it would not sell. The inability to move ahead with this project coupled with the cancellation of the high-speed 747X meant that Boeing had lost to Airbus on these two fronts and in effect withdrawn from passenger airline production altogether. The entire industry is watching to see if plans for the 7E7 can be revived.

Japan's Involvement

Boeing has found in Japan a key partner in helping it out of current problems. The Japanese aeronautics industry is well known for the World War II "Zero Fighter" but since the war has never regained its status, one major reason being that this technology has potential military uses. Production has been limited to the YS11 propeller-driven craft in the 1960's, and production on a sub-contract basis by a consortium of three companies -- Mitsubishi, Kawasaki, and Fuji Heavy Industries -- for Boeing.

It has been the dream both of the Ministry of Economy, Trade and Industry (METI) and the industrial sector to revitalize Japan's aeronautics industry. Noting this, Boeing will offer the three large companies 35% of the 7E7's developmental responsibilities in exchange for assuming a portion of the financial burden. The three companies in the past have been limited to 20% of the sub-contractual work, but this time, in addition to the additional production work, they are taking responsibilities for the risk. The airline industry is now being aided by a METI-financed foundation, The International Aircraft Development Fund (IADF).

But, will this "dream" bring happiness to everyone? The risk for Boeing and the Japanese makers is in fact minimized by the IADF's offering of $3 billion to the consortium in form of a low-interest loan. Therefore, if the 7E7 is not profitable the government and the tax-paying public will take the hit. Besides Japan, Boeing has a similar arrangement with an Italian maker. In all the American company is only assuming 35% of the financial burden. Boeing however has been forced to make this kind of international risk-sharing deal because of the lack of investment on the American side for the 7E7.

The EU has protested Japan's public-sector financing of Boeing as violating international trade agreements and placing the Airbus at a disadvantage. It is difficult to take this complaint take seriously since in the past IADF contributed to a joint project involving Japan, Italy, Germany, and England that developed the low-pollution V2500 airplane engine. In addition Airbus was directly supported for several years by both the French and German governments, with Boeing offering similar protests. Apparently, "free trade" has become a political term of late used in the service of national interest.

Japan as buyer

Whether or not the 7E7 sells will hinge wholly on developments within the airline industry. The views of Boeing and Airbus differ widely on this point. At present, there are about 1,400 mid-sized wide-body craft like the 7E7 in use. If present trends continue, Boeing will have to compete with Airbus's A330 etc., and the market for the 7E7 will be too small. However, Boeing anticipates that the demand for middle-size aircraft like the 7E7 will grow rapidly, and in the next twenty years it will sell 2,500 planes. As large cities complete new airports the range of possible activity has increased, but even as airline companies increase the number of craft to accommodate passenger preferences, the actual number of passengers on a single airplane is bound to decrease. Boeing therefore projects increased demand for mid-sized craft. In contrast, Airbus anticipates no change in the use of large-size craft and predicts sales to continue as in the past, projecting eleven hundred sales over the next twenty years. There is no competition for the 555-seat Airbus A380 now that Boeing has cancelled its 747X, but Boeing projects sales of only three hundred of the European craft over the same period. Each company has immense confidence in their positions.

With voices still raising doubts about the 7E7, Boeing's board of directors last November postponed a final go-ahead on the model's development. Boeing has placed its bets on Japan. The internal market is large by any standards, and the airlines are a prime customer. By 2009 the additional runway at Tokyo's Haneda Airport will be completed, relieving congestion and increasing it's the airport's capacity. As the best prospective market for mid-sized craft like the 7E7, the Boeing board of directors in their December meeting decided to make all efforts to secure deals with Japan Air Systems (JAS) and All Nippon Airways (ANA). In late November Boeing vice president of engineering, manufacturing and partner alignment, Walter Gillette, visited Tokyo and met with JAL and ANA, to appeal to the "dream" of a Japanese air industry and encourage the government to back the purchase of 7E7's. At the Tokyo Press Club Gillette later said "The airlines are very interested... We believe the 7E7 will fit very well with the needs of Japan Airlines and ANA in the future," and on December 17 the Boeing board gave its approval. Boeing finally has its first new design in thirteen years.

Asia Fills the Vacuum

The future passenger jet market is China. Boeing was able to pressure Tokyo politically to get on board so investors would approve the 7E7 but that pretty much delineates the company's interest in the country. Changing company fortunes created this interest: At present profits primarily are generated through military contracts, but the scandal causing CEO Condit's resignation in December, plus several others in marketing, raises the possibility of complete withdrawal from this industry.

The choice for Boeing is clear. A similar loss of public confidence in the 7E7 would mark not only the end of the company's involvement in

passenger craft but likely Boeing as a whole, leaving the market solely to the European Airbus. With industry hopes resting on China and the rest of the Asia region, Japan plays an important role. Until now America has been dominant in this region, but the possibility exists that it will lose out. Boeing's disappearance would leave Japan as a subcontractor for Airbus. There also remains the possibility that the giant industrial companies of Japan, China, and Korea will form a consortium and create their own Asian Airbus company. Such a large-scale dream has been meted out to METI's handmaiden IADF, now much more plausible with the end of the American prohibition against a Japanese aircraft industry. Japanese sights are set beyond the 7E7.

Shifting National Commercial Interests to Neighboring Countries

What are the prospects for Boeing's passenger aircraft as the US domestic market recovers from 9-11? Headquarters has already moved from Seattle to Chicago to facilitate Defense Department contract negotiations, forcing one to question Boeing's commitment to passenger craft. The airplane construction industry is extremely complex, as it requires both a high-level of technical expertise and political skill in marketing. Given that, if done well the profits to be reaped are huge. For Asian countries, with little history of industrial cooperation, to come together and form their own company a good many hurdles exist. Airbus, however, initially formed as a coalition of the weak and when it made its first A300 in 1972 it was only able to achieve sales in countries associated with the company. Boeing laughed, but now the tables have turned.

Not only the airline industry but other industrial sectors provide opportunities for inter-Asian cooperation. For this to occur, however, Japan must stop exhibiting, at least to other people, a "center of the region" mentality. Although we may be still on top in technical expertise and capital investment capacity, China may surpass us in future and thus the outlook must be one of equanimity. Japan has its own kind of "yellow journalism" that casts a cold eye towards China and Korea. Such an outlook is unhelpful, even harmful for the future. However, Japan may well find advantages in taking a closer look at Shanghai over the investment coming from the US. It is a route to consider since commercial activities and cooperation with China, Korea, and other regional neighbors will support Japan's economy in future.

Indeed, it is also possible that Japan has taken American long-term supremacy too much for granted without paying enough consideration to its own ability to counterbalance America's dictation of the terms of discussion. With an eye to the future, it may be worth paying greater attention to the possibilities of inter-Asia cooperation.

Translated for Japan Focus by Adam Lebowitz

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