Japan II

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Understanding the Japanese Enterprise

Till recently, management gurus were showering accolades on the Japanese manufacturing firm and its lean, flat, flexible, high-commitment, network commonly known as the Kirietsu. Japan successfully weathered a series of external shocks—the two oil crises of the 1970s, the dramatic increase in the value of the yen in the mid-1980s and growing import restrictions in its major markets. Indeed, corporate Japan seemed to emerge stronger from each crisis. Japanese auto firms convincingly demonstrated throughout the 1980s that key elements of the Japanese production system could be transferred to plants in North America and Europe.

But in the 1990s, Japan's economy has been plagued by an apparently intractable recession at a time when the US economy has been growing smartly. This has eroded the legitimacy of Japanese style management. Skeptics have begun to argue that the Japanese style of management is on its way out. To understand where the truth lies, a careful analysis is necessary. A historical prospective is in order here.

The Japanese Enterprise Model

The distinctive features of the social organization of Japanese factories were first brought to the attention of Western and Japanese social scientists in 1958, by James Abegglen. He identified the employment system as the key distinguishing feature of the social organization in Japan. The Japanese employment system, was characterized by:

- An employment system that recruited managerial, white collar, and blue collar workers directly after school graduation, after careful screening, and provided all three categories of employees employment security;
- The minimization of differences across blue and white collar workers, embodied in seniority-based reward structures, extensive training both on and off the job, and bonuses based on company performance for all categories of permanent employees;
- A co-operative and interactive industrial relations system characterized by the system of enterprise-based unions and annual wage negotiations;
- A managerial ideology that defined the enterprise as a community, and accepted the employees' stake in the company, a stance which entailed a commitment to maintaining employment, and acknowledged, at least in rhetoric, the enterprise's obligations to the larger society as well as to its employees.

Research on the Japanese Production System revealed several unique features:

- Flexible, team-based work organization: Individuals were assigned not to clearly defined jobs but to groups or teams, with considerable rotation across activities within each group.

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- Tapping the knowledge of all employees: Employees were encouraged to make and implement suggestions for improving quality and productivity, drawing on their knowledge of the production process.
- Dense networks with suppliers, embodied in "Just-in-time" logistics and the elimination (or drastic reduction) of inventory for final assembly, so that parts and subsystems were "pulled" onto the production line as needed, and suppliers were fully integrated into production planning and product design;
- Dense networks with partners, with production tied to demand from customers, through close links to distributors and retailers, to ensure that the output matched the needs of the market, and the production system could respond to rapid model changes according to demand;
- Close integration of the factory and product development and design, with development laboratories often co-located with key factories and the movement of people from product development into manufacturing.

The Japanese production system relied heavily on external and internal networks. It believed in promoting generalists at all levels of the company, from the blue collar workers who maintained their own machines and cleaned their own work areas to the engineers with graduate technical degrees who moved over the course of their careers from the central laboratories through the factory-linked development facilities to line management in the factory. Also, the different functions within the company were closely linked, even overlapping. Suppliers delivered direct to the production line and customer orders passed directly to the factory.

Subsequently, much of the debate over the uniqueness of the Japanese model had shifted from the analysis of the Japanese factory to the analysis of the Japanese firm. Research established the following differences between Japanese and US firm.

- Japanese companies favored growth while US firms wanted profitability;
- Japanese manufacturing firms were typically less vertically integrated than their US counterparts. They also had a smaller number of external suppliers;
- Japanese firms were much more likely to favor strategies of diversification through internal growth into closely related arenas. US firms were more prone to pursue strategies of acquisition and of unrelated diversification;
- Japanese firms preferred export strategies, gradual incremental establishment of offshore production, and the establishment of functionally specialized subsidiaries closely tied to the parent company in Japan rather than the development of the strong, integrated country subsidiaries that characterized American MNCs.

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Various explanations have been offered to explain these differences. The use of subsidiaries for horizontal diversification by the lead firm in the group is probably a risk-shifting strategy: That is, in new business areas, where the firm is stretching its capabilities, a separate enterprise avoids putting the name and the resources of the parent firm at risk. This is important in the Japanese business context, where the lifetime employment system precludes exit from unsuccessful business and where reputation is seen as a more important business asset than in the US.

Japanese firms also seem to encounter diminishing returns to scale more quickly than their US counterparts. This may be because of the enormous complexities of the Japanese written language. As a result, Japan never really experienced the first office revolution introduced by the typewriter. The co-ordination and control systems of many Japanese firms rely heavily on face-to-face interactions. Such systems function less effectively in very large, vertically integrated firms than do more impersonal, less information-intensive systems.

Vertical and Horizontal Linkages

Various reasons have been given to explain the emergence of the vertical Kirietsus in Japan:

- The disaggregation of activities along the value chain makes costs more transparent and therefore controllable.
- The lead firm can focus on core high value adding activities.
- Even large firms can stay relatively small. In 1990, only eleven Japanese manufacturing companies employed more than 40,000 people. Smaller size improves the flexibility and dynamism of the firm, helping it to move quickly into new related technologies and product markets.
- The lead firm is able to achieve more efficient compensation system, keeping only high value adding activities on its employment roster and rewarding its high commitment, high value adding employees appropriately.
- The "relational contracting" characteristic of the supplier networks of the *keiretsu* — management by "contact, not contract" (Mishina and Flaherty, 1997) has reduced coordination costs, fostered the expansion of supplier capabilities and "co-specialized assets", and lowered production costs.

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One of the key skills of Japanese companies is managing the linkages across companies in the network. Managerial capabilities are less transferable across keiretsu than in industrial forms that depend more heavily on analytical skills and impersonal co-ordination and control systems. The lower inter-firm mobility in Japan may therefore be as much due to the vertical network as due to any cultural preferences for loyalty and stability of employment.

In the Japanese corporation, most shareholders are not individuals or institutional investors seeking immediate returns, but companies, whose interests have focused on its continued viability rather than their own financial returns. As a result, Japan does not have an active market for corporate control. Companies in Japan are acquired by other companies only by mutual consent. Mergers and acquisitions have been relatively rare events. The Board of Directors is not composed of external representatives of shareholders but of the company's own executives and former executives. If there is an external person on the Board, it is usually a representative of the lead bank.

The "lead bank" role in the Japanese business system has been the subject of extensive research. Before the "bursting" of the Bubble Economy in the early 1990s, the lead bank was widely regarded as the entity which would put the brake on managerial actions that might endanger the viability of the firm. The lead bank had two conflicting roles. As a creditor, it was concerned with the long-term viability of the company; as a lender, however, it had its own interests in expanding its business with the company by encouraging it to borrow money and to turn to the bank for sophisticated financial products to fund expansion.

Japan is also famous for its conglomerates. The horizontal *keiretsus* are different from the vertical *keirestus* in scope, number, and structure.

- Where the vertical *keiretsu* operates within an industry, broadly defined, the horizontal *keiretsu* consists of firms from virtually every major industry in the economy.
- While virtually every large Japanese firm heads a vertical *keiretsu*, there are only six horizontal *keiretsus*, which were formed in the 1950s. Three are direct descendants of the prewar *zaibatsu* (Mitsui, Mitsubishi, and Sumitomo), and three have been formed at the initiative of banks, and also have their roots, less directly, in the prewar *zaibatsu*.
- The Horizontal *keiretsu* are much less tightly coordinated than the vertical *keiretsu*. There is no single dominant firm in the horizontal *keiretsu*, and no hierarchical control structure. Whereas the vertical *keiretsu* has a cascading structure of shareholding and of personnel transfers (from lead firm to first-tier suppliers, from first-tier to second-tier, and so on), the horizontal *keiretsu* is characterised by cross-shareholding across the

various member companies. Personnel movements are much more limited and concentrated at the level of the Board of Directors.

A Dual Economy

Till the recent recession, the Japanese economy had been one of the world's stellar performers. From 1985 to 1991, it grew from one-quarter to one-half the size of the U.S. economy. Japan's consistently favorable balance of trade and the amazing ability of its well known companies like Sony, Matsushita, Toyota and Honda to penetrate overseas markets became the envy of the world. But what remained less well known was that even during this period of rapid growth, government policies effectively created two Japans: One composed of highly productive export oriented industries, the other made up of inefficient inward looking companies. Michael Porter has driven this point home in his book, *"Can Japan Compete?"*

Even during the height of Japan's success in the 1980s, globally uncompetitive companies employed 87 percent or more of the nation's workers. Indeed, it was a handful of industries within Japan or more precisely a handful of companies within each of those industries that brought prestige to the nation. Because the truly successful companies were so successful, they provided government with the resources to subsidize those that were weaker. The Government decided to prop up weak companies rather than expose them to the rigors of global competition. These companies never grew tough and became addicted to government support.

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The great majority of Japan's domestic businesses, account for approximately 80 percent of the Japanese economy. They wage their competitive battles almost exclusively within the confines of Japan's insular home market. Japan's national tastes, quality and safety standards, unique business traditions and myriad formal business regulations have made it difficult for companies outside Japan to penetrate the domestic market. Lack of international competition has created a sense of complacency especially in the service, construction, and food-production sectors.

The Government hoped that while the efficient Japan would carry the economy, the inefficient Japan would provide stability, jobs, self-sufficiency, and an implicit retirement system of small family businesses. But these inefficiencies have driven up business costs across the board, weakening the competitiveness of the export oriented industries. It has also prevented the formation of globally competitive industries in many segments of the economy.

Not only that today, many of Japan's global giants seem to be in trouble. The country's once-mighty automotive and consumer electronics industries look vulnerable. To cut costs, they have already transferred most of their operations to lower-cost regions outside Japan. The production capacity for three million cars per year went to North America, and the production capacity for much of Japan's consumer electronics to Southeast Asia. While the competitive firms have shifted operations outside Japan, the same old troubled, uncompetitive industries, which cannot survive without subsidies have been left behind. So, the domestic industry looks even weaker than in the past.

Understanding the Government's Role

The Government's role in Japan's industrial development has also been misunderstood in the West. Looking back, in many cases, the Government has been given credit or blamed for the wrong reasons. At the start of Japan's industrialization, the Government felt that no corporation had the proper perspective to take part in the nascent economy. It realized the need to target some industries which had better growth prospects and which could support a higher standard of living. Others had to be sheltered to grow and gain scale to compete internationally. These calculations led to government-sponsored co-operative Research and Development (R&D), lax antitrust policies, officially sanctioned cartels, subsidized activities, and intervention in declining industries.

A careful analysis of Japan's industrial growth reveals that in each decade, internationally competitive industries have resulted with little or no government support—motorcycles (1960s), audio equipment (1970s), automobiles (1980s), and game software (1990s). In many other successful industries, ranging from robotics, sewing machines, fax machines, and home air conditioners to carbon fiber and soy sauce, government intervention was again almost entirely absent. There were no major subsidies and no efforts to limit competition.

A study conducted by the famous management guru, Michael Porter reveals that in many of these successful industries, the Government has played a variety of unexpected roles. The Government stimulated early demand for new products in some industries. For example, it heavily promoted the office use of fax technology and encouraged government agencies to accept it early on. The Government quickly embraced global standards to ensure that all fax machines were compatible. In the early 1980s, the Government made fax documents legal for many purposes. This generated early demand for sophisticated machines and spurred Japanese companies to invest in the industry and improve their products. Similarly in the case of robotics, a government-supported leasing system encouraged robot use among small and medium-sized companies. In some cases, stringent government standards triggered innovation. In home air conditioners, the Japanese Energy Conservation Law (1979) accelerated efforts to reduce energy use and led to the invention of the rotary compressor.

> ***Intense competition has been the driver of Japan's internationally successful industries***

In contrast to these successes, faulty government intervention resulted in failures in many other cases-consumer goods (apparel and detergents), advanced manufacturing (civil aircraft and chemicals), services (financial services and computer software) prepared foods (chocolate), and chemicals. In chemicals, the Government controlled production levels. In securities, over regulation by the Government and fixed commissions resulted in an oligopoly of just four (now three) players. In detergents, the Government protected the home industry from foreign competition, effectively leaving two companies in control of the market. In contrast, intense competition has been the driver of Japan's internationally successful industries. In air conditioners, more than a dozen rivals competed aggressively with each other, while there were well over 100 robotics companies and more than 15 fax-machine producers.

Demanding Customers

An aspect which has not received adequate attention in the literature on Japanese management is the sophisticated and demanding nature of the country's customers. When consumers are knowledgeable and demanding, companies have to work harder to meet their expectations. This automatically makes them more competitive globally. Quality, safety, health, and environmental standards often enhance customer sophistication and put pressure on companies to use more advanced technologies. In robotics, Japanese manufacturers moved to large-scale robot use much faster than companies in other countries because of their sophisticated manufacturing practice, shortage of skilled workers, and caution in hiring due to lifetime employment. In the fax machine market, the problems posed by the Japanese language for typewriters and telex machines, office space constraints and expensive telephone charges all meant producers had to meet stringent local needs.

The pattern of domestic demand, sometimes shaped by geographical and cultural factors, has also had a significant influence on the competitiveness of Japan's industries. Japan is a nation of small, closely packed houses and hot, muggy summers—hence a strong local demand for compact, quiet air conditioners. Over time, knowledgeable consumers have pushed manufacturers to improve product performance and add new features. Following the oil crisis of the 1970s, the Government set stringent energy standards that triggered additional innovation. In detergents, on the other hand, the Japanese market is so different from the rest of the world that home demand distracts Japanese companies from becoming globally competitive. The same energy and space constraints that led to successful air conditioners resulted in small washing machines and frequent loads. This, coupled with softer water, produced detergents of lower quality than those required by foreign customers.

Corporate Sector at the Cross Roads

Today, the Japanese corporate sector stands at the cross roads. Many of the country's largest companies have announced plans for drastic reductions to their workforces. These include Toshiba, Sony, Mitsubishi & Nissan. Matsushita, which epitomizes the art of Japanese Management, recently announced that it would slash costs by centralizing R&D and marketing activities, salary cuts and plant closures. In 2001, 13,000 employees making up 10 percent of Matsushita's workforce volunteered for early retirement. In 2002, top executives are expected to take a pay cut that will amount to $385 mn. Five subsidiaries are being merged with the parent to eliminate duplication of products and rationalize R&D efforts. Meanwhile, pressure is increasing on Matsushita to increase outsourcing and shift more work to a cheaper location like China. But bulk of Matsushita's plant closures and retrenchments are still taking place outside Japan.

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There have also been some high-profile bankruptcies. In October 2000, Chiyoda Mutual, the life insurer, became Japan's largest ever corporate collapse with debts of Yen 2,900 bn. Retail chain Sogo, went under in July 2000 with debts of Yen 2,000 bn, while Mycal, another retailer, filed for court protection in September this year, with debts of Yen 1,740 bn. Government statistics estimate that Japan is currently losing 178,000 jobs a month, This has pushed unemployment rate above 5.4 percent, an all time high. The figure for those aged under 24 is estimated to be around 10 percent.

Underlying these trends has been the splitting of webs of relationships that linked business, the government and the banks. In the automotive industry, the keiretsu system is being broken up. Suppliers are being sold, merged, listed or closed. The proceeds are being used to reduce debt. Banks are unwinding their cross-shareholdings in Japan's top industrial groups and are under increasing pressure to withdraw credit lines from companies that stand little chance of being able to repay their debts.

Meanwhile, as mentioned earlier, many leading companies are shifting their production facilities to cheaper locations. Sony, recently announced it would assemble and sell its high-end Vaio brand personal notebook computers at an existing facility in Jiangsu province. Toshiba held an opening ceremony in October for a new copier factory in Shenzhen, which will be responsible for three-quarters of its total production of copiers. Mazda has plans to begin production of sports utility vehicles in Haikou. This furious pace of outsourcing by larger companies has hit Japan's domestic manufacturing sector particularly hard.

There has also been a flood of lower-priced manufacturing goods from abroad. The trend has been exemplified by the rise of the new generation retailers like Fast Retailing, which import items directly from factories in China. Priced significantly cheaper than other brands, this retailer's sales have exploded and competitors have been forced to lower prices. This has attracted protests from domestic manufacturers and farmers unable to compete with such low priced imports.

Along with swathes of uncompetitive industries, Japan is weak in services. The inability of Japan to develop a world class service sector has been attributed to many factors. Much of Japan's domestic service sector either requires or tolerates levels of employment that would be considered unusually high in other countries. Japanese department stores, specialty retail shops, and banks provide service personnel (like elevator operators) who in the West would either be replaced by customers themselves, or would simply be absent — greeters and receptionists, for example.

Even in businesses where automated equipment exist, human workers still stand by, performing redundant functions. At airports, boarding passes are inserted into a machine that retains the airline's portion and returns the passenger's stub. This simple transaction, which could easily be operated by passengers themselves, is handled by two workers. The first takes and inserts the pass, and the second hands back the stub. Worker productivity is hence low across the full spectrum of service industries in the Japanese domestic economy.

The legitimacy of the Japanese business system has also been affected by the erosion of the credibility of other elements of the Japanese business environment, most notably the nation's political institutions. The squabbles among the factions and the fractions of the LDP (elements of which have broken off to form new parties, often with little to distinguish them but the men leading them), a series of scandals and even corruption in the hitherto sacrosanct bureaucracy, and the failure of the Ministry of Finance to respond effectively to the recession and the banking crisis have all contributed to a widespread disillusionment with Japan's institutions overall. In this scenario, Japanese corporations have also come under a cloud.

But it would be wrong to underestimate corporate Japan. In several industries, Japan is quite competitive. A new generation of entrepreneurs who can take tough decision seems to be emerging. Among the current group of politicians, no one has professed the need for change more than Prime Minister, Koizumi. With more determination and a bit of luck, the Japanese enterprise can be expected to emerge in a more revitalized form. ■

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Factors Involved in Divestment Decisions

Categories	Opportunistic	Planned	Forced
Economic		Never be a factor at any investment level	
			Continual failure to meet goals
	Tax considerations	Tax considerations	Tax considerations
		Shrinking margins	
	Better alternative use of capital	Better alternative use of capital	
	Profit motivation	Profit motivation	
		Marginally profitable	
		Recover some capital	Recover some capital
		Unprofitable division	Unprofitable division
		Liquidity problems	Liquidity problems
Psychological		Eliminate psychological effect of a loser	
		Bad apple theory	
Operational		Lack of intercompany synergy	
		Labor considerations	Labor considerations
		Competitive reasons	Competitive reasons
		Management deficiencies	
		Concentration of management efforts	Concentration of management efforts
		Eliminate inefficiencies	

Source: Mergers, Acquisitions, and Leveraged Buyouts – Robert Lawrence Kuhn