4 The curse of "Japan, Inc." and Japan's microeconomic competitiveness

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Corporate Japan during the lost decades

Many Japanese companies that had once dominated world markets suffered from a declining market share and sluggish profitability during the lost decades (1990–2010). The fundamental problems arose due to the matured state of Japan's economy and also from external influences that were triggered by new trends – globalization and the digital revolution, which transformed the world of international business. The inability of Japanese companies to come to grips with these trends and to adopt corporate governance models to comply with the new world economic order led them to lose ground quickly in the global economy. Their demise is easily discernible from a glance at *Fortune*'s Global 500 List: in 1995, readers found 141 Japanese companies, but astonishingly only 71 in 2010.

Japan's single most abundant resource after World War II was its population, which meant the availability of a cheap yet educated workforce. In the 1950s labor costs rose, but the nation underwent a major structural shift from labor-intensive to capital-intensive industries through government-led policies, and this improved industrial productivity sufficiently to justify the higher labor costs. Once Japan had established a big enough domestic industrial base to support high economic growth in the 1960s through export-oriented production and external trade, domestic demand, sustained by an increasing population with a growing dispensable income, enabled in the 1990s the final transformation of the nation into a knowledge-intensive economy. This economy emphasized services and businesses reflective of twenty-first century needs. However, in the final stages, many major Japanese companies stumbled.

During the first half of the lost decades era, Japanese corporations suffered a setback when Japan's asset bubble collapsed in 1990. Management practices founded on lifetime employment and an outdated socioeconomic system (based on the "main banking system" and weak safety measures for responses to bankruptcy and merger and acquisition situations) impeded speedy economic recovery in the private sector. Problems surfaced related to excessive corporate debt, superfluous numbers of employees, and production overcapacity.

The stagnation that Japan underwent after the burst of its economic bubble was a complete first-time experience. Nothing like this had happened before in Japan or indeed any other country in the world. Japan's political classes were initially slow to identify and come to grips with the problem. Financial institutions dealt with accumulated nonperforming loans in an inefficient manner and market failure prevailed. The situation continued until Prime Minister Koizumi's administration (2001–2006), which swiftly launched initiatives to deal with the problem. The delay that resulted from the tardy response, however, contributed to the lack of any significant turnaround in the Japanese economy. (The EU is facing a similar situation now with the postponement of post-recession measures).

The resulting economic slowdown was so consuming in terms of time and energy for many Japanese companies that they could not direct their attention to the reforms that were necessary to stay competitive in a new environment that had been utterly transformed. There was also a strong home market bias that sidetracked product development and diverted corporate resources to domestic market needs, with little consideration given to product competitiveness from the perspective of a global customer base.

In this chapter, I will try to explain the drop in overall competitiveness during the lost decades with a look at the less-than-suitable management models that were applied by Japanese companies and that led to their failure to utilize the competitive advantages they had gained. The term Japan, Inc. has been used widely in media to illustrate mutual collaboration between governmental and corporate interests in Japan. In this chapter, we use this term to label the established domestic corporate system which was developed in the period of high economic growth and was sustained by three fundamental practices founded on lifetime employment, a system of seniority, and a harmonious relationship between management and labor unions. I will look at the example of the well-known electronics manufacturing company Sony, which even now is struggling in the face of stiff global competition. My view is that even putting aside internal factors, the responsibility for the drop in competitiveness lies mainly with the use of traditional approaches to corporate management and business models. These approaches had contributed greatly to Japan's previous success, but are now outdated: they could no longer handle changes to the new international business environment, which was fundamentally altered by globalization and the digital revolution. I will use Sony to highlight the strategic and structural failures and the causes that have affected the entire Japanese corporate sector.

Globalization in the 1990s and the decline of competitive advantage

Globalization, a profoundly overused term, tends to have various meanings depending on one's perspective and intended audience. In this chapter, I employ the term to describe a state in which the traditional definitions and categories of markets were fundamentally changed. Up until the 1990s, the world was divided into advanced and developing economies, and geopolitically separated – separated into blocs – by the Iron Curtain. When the Berlin Wall came down in 1989, borders opened, the Cold War system crumbled, and the economies of East and West united and transformed into something new. Many nations opened their markets and took a proactive role in new trading activities, which could now take place on a global scale. Globalization is founded on cross-border integration and the mutual exchange of people, products, services, capital, and ideas. Historical borders grew much less important than they had been before, and traditional strategies of manufacture and export were seen to have reached their limits.

The markets that emerged were ones that expanded rapidly and offered new opportunities for everyone involved in this new era of competition. Japanese companies were keen to exploit these opportunities. They faced several problems, however, in accessing the markets. For one thing, they were too focused on the traditional large markets in North America, Western Europe, and Japan, which in the 1990s still represented the largest portions of the world economy – this was a further reason why during this period the Japanese companies' home share shrank significantly. Data from the International Monetary Fund (IMF) for GDP shows that Japan's economy represented about 15 percent of the world economy in 1990, but shrank over time to 8 percent by 2012. In the 1990s, Japanese companies were consequently less proactive than their Western competitors in relocating their strategic capabilities overseas, especially to emerging economies such as Brazil, Russia, India, and China (the so-called BRIC countries). Most Japanese companies abroad typically had only a minor footprint, with only local sales and a small marketing presence or production site.

To some extent, already during the 1970s and 1980s, a new movement for cross-border integration aimed at seizing market openness and mutual exchanges began to modify the traditional strategy of manufacturing goods and providing services to customers. It became important to provide products at highly competitive prices by utilizing production localization, off-shoring, outsourcing, and other strategies used by all the corporations that were able to achieve their own cost leadership and maintain their competitive advantage in developed countries. Japanese companies were keen to locate new business opportunities and to find cost-competitive production sites overseas. They were less proactive, however, about bringing a long-term vision to their strategically integrated capabilities and shaping the markets in emerging countries so that they could be equivalent to their already established main overseas markets in North America and Europe.

Japanese corporations invested during the early 1990s in Southeast Asia (Shiraishi Takashi discusses the politics behind such decisions in Chapter 11). However, as the currency crisis hit the "Asian Tiger" nations, many enterprises had to downsize local operations or withdraw completely, retracting their operations, and return home. This suggests that these local operations were nothing more than low-manufacturing-cost centers. Simply put, the "new" strategy Japanese companies were employing at this time was just an extension of Japan's classic trade policy as a "processing" nation (employing cheaper labor at a local site and exporting goods to the rich consumer markets of developed countries), which had given Japanese companies their comparative advantage over American and European ones.

In the meantime, foreign direct investment had brought about a transformation in the industrial capabilities of these emerging nations. Further, as local industries became increasingly stronger, it became much easier for these nations to gain access to capital markets – and this accelerated local industrialization. Vigorous competition within these emerging economies started to erode the conventional advantage that had once been enjoyed by the major Japanese companies, in the electronics industry for example, that at one time had been able to dominate tradable goods markets.

There were two reasons why the traditional economic model that had been based on simple processing and external trade (the model that lay behind the Japanese economic miracle during the era of high economic growth) was no longer valid. First, the strength of the Japanese yen together with high labor costs undermined the ability of Japan to compete directly with companies from emerging economies in terms of manufacturing costs if they wished to preserve Japanese domestic assembly operations. Second, globalization led to a larger-than-expected market diversification, and Japan's focus on mainly North America and Western Europe became less ideal as emerging economies positioned themselves to become larger contributors to global growth.

Adaptation to globalization

As globalization proceeded, European and U.S. companies with overseas operations began to hire more local business talent with the requisite local market insight, with a view to increasing operations in regional markets. Clearly, it was essential to have a range of key decision makers for success. Japanese companies hired local staff but continued to entrust control at top levels within the organizations only to Japanese managers. Needless to say, globalization impacted the world of business both domestically and abroad. Their tardiness in diversifying their markets and involving local human capital meant that Japanese corporations were slow off the mark in identifying market potential in comparison with their Western counterparts. Even today there is a marked lack of diversity in their executive boards and management circles, not only in terms of nationality but also of gender – women are still significantly underrepresented in the Japanese workforce. (Andrew Gordon explores these issues more fully in Chapter 5.)

Japanese companies were on the whole unsuccessful in dealing with globalization. European and U.S. companies, which had languished in the shadow of Japan's success in the 1970s, generally handled the need to adapt much more skillfully and produced significant results. During the years during which Japan had reigned supreme, some European and U.S. companies had been forced to exit the market. But others took the opportunity to reform their management models and strengthen their operational capabilities. In some cases they adopted an action-oriented decision-making process (sometimes by studying Japanese management practices such as total quality management and reconfiguring their corporate businesses portfolios accordingly) that eventually led them to outpace the Japanese management systems. The results of these strategic reforms are clear to see in a famous study by the MIT Commission on Industrial Productivity, "Made in America." Neither European nor U.S. companies did at all well in the Japanese domestic market at this time. The trade friction caused by structural impediments eventually developed into a political issue, but the truth was that Western corporations simply looked down on the Japanese market and failed to fully grasp the increasingly refined needs of domestic consumers. Notwithstanding their perception of Japan as a small and distant island in the Far East, strong Japanese competitors had already emerged.

Japanese corporations were on the whole enjoying great success abroad, and most business leaders still believed in the worth of their traditional corporate model. A similar trend can be seen today in the Chinese automotive industry where U.S. and European manufacturers dominate the market, despite their geographical distance from China.

The latest studies show that innovation practices created in emerging markets nowadays, such as those of India, are being transferred back to developed nations through a similar process of reverse innovation, with excellent results. This is in sharp contrast to most Japanese companies, which for the most part remain locked in their own practices and continue to underestimate the need for low-cost products in emerging markets.

New competitors and repetitive history

The era of the lost decades was the first time that Japanese firms had to face new Asian competitors: companies from Korea, Taiwan, and China. Somehow Japan, or Japan, Inc., had completely shut its eyes to these emerging market champions and ignored them as worthy competitors, only to discover that this was a grave mistake. Such behavior resembled the actions of European and American major companies toward Japanese companies in the 1970s and 1980s.

In contrast to Japan, Inc., European companies had come to grips with their own geographic constraints and the lack of scalability in their domestic markets, so they lost no time in establishing well-globalized operations. Japanese corporations clearly played a much safer game and relied extensively on their own domestic market. Japan had after all been the second largest economy in terms of GDP until 2010, before being overtaken by China. The traditional export-oriented trade business model was based on decisions being made at Japanese headquarters, and there was consequently never the need to evolve into a fully globalized corporate structure. The business model was extremely simple: raw materials were imported to natural-resources-lacking Japan, processed into finished goods, and then sold in the Japanese domestic market or exported mostly to Organisation for Economic Co-operation and Development (OECD) destinations. This model made overseas operations quite manageable, with sales and marketing offices in OECD countries and production sites in emerging countries. The only exception was a number of OECD countries where a manufacturing presence was maintained for political reasons, such as to prevent trade-related friction and secure local political support.

Given this structure, it comes as no surprise that all core managers in these operations were Japanese and the most important actions and decisions were carried out in Japan. Most Japanese managers did not catch on to the fact that globalization had brought a completely new environment, in which products and services were developed, produced, marketed, and managed in a much more delegated way, with much less centralized control. Even today, despite the shrinking and ageing population that Seike Atsushi describes in Chapter 1, the fiscal deficit as explained by Kuttner, Iwaisako, and Posen in Chapter 2, and the related macroeconomic issues summarized by Kobayashi Keiichiro in Chapter 3, Japanese corporate structures remain firmly attached to traditional principles – trapped by their glory days.

The digital revolution and changes in the game

The rise of digital technology in the early 1990s fundamentally changed the way products and services were designed, produced, and delivered, as well as how people communicate and interact every day. For a variety of reasons, however, the digital revolution did not suit Japanese companies and their management models.

The first reason was that modular designed technology eroded the value of the assembly process, which was where Japanese companies had always displayed a strong competitive advantage. The shift to this modular architecture was problematic for Japanese companies in that they relied on concurrent engineering and interdivisional coordination – the underlying keystones of integrally designed technology. This contrasting approach and capability was based on the long-term accumulation of technological and business expertise, enabled by the stable employment system provided by Japanese corporations.

Various strategic approaches were adopted by companies to deal with the changes brought by the arrival of the digital revolution, especially in regards to the value chain. Some Western companies focused solely on a specific layer in the value creation chain and became known as horizontal ("layer") champions. Microsoft, with its operating systems and office productivity products, was one such example. Others outsourced the less value-added manufacturing or the fabrication process. This became a popular move in the semiconductor industry, with Texas Instruments and Freescale establishing themselves as "fabless" players. This strategy allows for focusing and dedicating internal resources to technology development, product design, and marketing, while using external manufacturers for the actual fabrication.

To respond to manufacturing outsourcing needs, a new type of company with a pure focus on the assembly process also emerged. This business model, exemplified by Foxconn, relies on concentrating production to regions with a low labor cost. As manufacturing technology became widely accessible and commoditized and was pursued on an intensive global scale, the company became large enough to secure global orders from final assembly manufacturers that were shifting to a horizontal specialization model. The emergence of these competitors complicated the situation for the Japanese electronics industry, which was trying to preserve its traditional structural competencies based on vertical integration business models and a focus on high-quality products with high labor costs. Total solutions providers, such as GE, IBM, or Siemens, represented another approach. Japanese manufacturers cannot pride themselves on having adapted this model, as they have traditionally depended on the added value of their products as the main contributor to their value proposition instead of focusing on comprehensive turnkey solutions.

The digital revolution increased horizontal specialization efforts, which allowed for the breakdown of value chains in the industrial structure. The information and communications technology (ICT) sector particularly followed this trend. Strategic decision making was required to reassess each company's business strengths, during which their true competencies in specific layers of the value chain were apparent. Customers were willing to pay the most for delivered high-added value. In addition to traditional corporate portfolio management theory, competition called for an ongoing "choose and focus" strategy, which concentrated on a given company's value chain. This strategy required flexibility, speediness, and extremely dynamic strategic behavior for the execution of large-scale transformation or disposal of business units and functions, as was seen in the case of IBM selling its personal computer business to Lenovo in 2005 or Apple's "fabless" strategy with a focus only on design, marketing, and user interface.

Semiconductor memory chips, large-size LCD displays, and other similar devices once relied on complicated production technology and the need for highly skilled workers. Japanese electronics manufacturers had previously dominated their markets. With the digital revolution, however, this changed significantly when these device products became scalable. At the same time, core production technology was shifting to manufacturing equipment producers: if sufficient capital funding could be obtained, technology-related competitive obstacles vanished, which lowered the barriers to the market. In this business domain, financial muscle combined with an ability to make speedy and bold investment decisions to overpower technological capabilities and competition became a power game in which Japanese companies slowly lost their competitive edge. The initial successes of Elpida in DRAM chip manufacturing and Sharp's concentrated effort in LCD displays were made possible by this "choose and focus" strategy. However, this technological predominance as a competitive advantage was not sustainable.

Machinery and automotive manufacturing also felt the influence of the digital revolution, but because their business models centered on concurrent engineering and vertical integration they continued to function well and suffered less significantly than players in the Japanese electronics industry.

The second reason that Japanese companies did not fit well in the digital age was that the so-called productivity enhancement that IT systems brought into the corporate environment did not in fact bring about the desired effect.

Unlike their Western competitors, the Japanese proved unable to gain the full benefit from the cost savings that were supposed to accompany productivity enhancement, since the established system of lifetime employment did not allow for replacing labor in a comparably radical way, due to productivity increases gained through enhanced IT technology scaling. Despite the common notion that Japanese companies did not invest in IT technology as much as their Western competitors, this is not quite true – a 2008 Yano Research Institute survey concluded that Japanese corporations on average spent more than twenty-one months customizing enterprise resource planning (ERP) solutions (business management software) to their specific needs, whereas American firms spent only eighteen months. The overall process of externalizing and outsourcing routine work functions in Japan was much slower and structural reorganization was often blocked due to employment laws and protective labor practices. Such problems abounded across all industrial sectors, and from the 1990s into the 2000s overall productivity in Japan was improving at a much slower rate than in the United States.

With increased attention to IT stemming from the so-called Y2K problem, many large enterprises in Japan began introducing and adopting ERP (Enterprise Resource Planning) systems. Nevertheless, the lifetime employment system still prevented corporations from making any significant staff reductions that might have led to streamlining and operational optimization. The internal decision-making process, characterized by an institutionalized requirement of consensus, combined with an aversion to general process standardization throughout the corporation's global operations, prevented the implementation of large-scale corporate reorganization measures. Most surprisingly perhaps, ERP solutions tended to be customized to fit in with established organizational practices – not the other way around. As a result, system-related cost reductions were never met and standardization of indirect operations, such as accounting, never made. This morass led to the loss of the opportunity to improve overall corporate productivity by slashing heavy and fixed costs.

The third reason why increased digitization did not suit Japanese corporations was that the fast-growing industries established by the new wave of internet technology generally supported younger and much more agile corporations. These venture players in this new and fast-growing area were less vertical and more horizontally integrated in terms of hierarchy and they had a direct, streamlined decision-making process. The companies in "Japan, Inc." were by their very nature much more conservative and slow moving, and they found it difficult to adapt. Even in the United States, with the introduction of personal computers into the workplace and downsizing, horizontal integration with its focus on the same level of the value chain led to an emerging class of new technology companies – Microsoft and Intel, for example, as competitors to large, well-established, and technologically strong enterprises such as IBM. Google and Facebook later eroded Microsoft's dominant position with the emergence of social media, and Intel Company had to defend its leading position from Qualcomm, a microchip manufacturer that had been aggressively expanding due to the explosion of mobile devices. Apple, which had at one time been on the verge of bankruptcy due to the Wintel alliance (the combination of Windows and Intel processor-power computing), managed to completely resurrect itself by attracting customers back during the internet and mobile device revolution.

Moreover, the new approach of what is called "open innovation" proved to be much more efficient than the traditional closed model. By foregoing complete control and inviting external solution developers to resolve issues, open innovation has proven to be the principal driver of growth in the ICT industry, and continues to be so even now. As a result, in the business-to-customer (B2C) domain, young entrepreneurs thrive with the use of their particular brand of executive leadership skills, but the large and well-established electronics companies of Japan were handicapped. Even the once globally dominant Sony was not spared difficulty, as we shall see later.

In short, Japan, Inc. was not able to come up with adequate responses to establish a new "industrial ecosystem" in the new digitized environment that would nurture risk taking. This was absolutely key in the creation of new ventures that thrived in new competitive regions such as Silicon Valley. As a result, companies in the high-tech space had to face fierce new realities. In fact, in the 1980s the Japanese government had already identified shortcomings and had made attempts at countermeasures. Financial institutions, at the center of this effort, made efforts to shape the conditions necessary for nurturing new business and attracting venture capital. Nevertheless, no significant results were achieved. In Silicon Valley, we find fundamental differences in the ways in which industry and educational institutions collaborate and in the nature of the culture of the industrial community. It is only very recently that we have seen some progress with the start of comparable ventures in Japan that attempt to target global markets from their very inception, in companies such as LINE, a Japanese messaging application provider that was launched in 2011.

The Galapagos syndrome/one-village mentality/ home-market bias

Another trait that is identified with the lost decades was the emergence of what is now popularly referred to as the "Galapagos syndrome." This term was originally coined to refer to Japanese 3G mobile phones that dominated Japanese markets and that had developed a great number of specialized features using the miniaturization so favored by Japanese electronics manufacturers, but that were totally different from any comparable device offered by global competitors – and thus unable to be used outside Japan. The name Galapagos refers of course to the highly evolved but thoroughly singular flora and fauna that Charles Darwin encountered on the Galapagos Islands that led him to make key connections in the development of evolutionary theory, and draws a parallel with the highly evolved nature of these phones and their complete divergence from anything outside of the islands of Japan.

Japanese cellular phone companies designed products solely for the Japanese domestic market, targeted for usage in Japan only. The highly complex functions of the phones relied heavily on the high-spec hardware components inside them, and the industry ignored the potential sales of such equipment overseas. This way of thinking eventually determined the fate of the phones, as the advances of smartphones and mobile applications, which made further customer adaptation and customization easier, overtook them. In essence, there was a neglect of any strategic aims to further develop the software capabilities of Japanese phones and the manufacturers failed to foresee how the digital revolution would fundamentally change the competitive landscape of the global consumer electronics market.

Not all Japanese management groups failed to understand the need to evolve and adapt to business in the outside world – Sony and other companies did attempt various reforms. But, as I explain later, the very success that Japan had experienced with its long-term communitarian "*kaisha* model" (*kaisha* means "company" in Japanese, with connotations of an essentially inward-looking operation – a "firm" that is set in its established ways) characterized by lifetime employment, a seniority system, and internal labor unions, made it difficult to effect a shift in the corporate mindset.

The most defining characteristic of the communitarian *kaisha* model was the decision-making system, which itself was strongly based on the "one-village" mentality, in which all action and decisions take place within a tightly controlled and confined arena, mostly limited to one company, or one company and its close partners. The single most important aim of this decision-making process is the preservation of internal harmony. The opinion in each division is coordinated through consultation, which is extremely time consuming: all related parties meet face-to-face and a consensus is formed through a bottom-up decision process. After decisions are made, progress to the execution stage is usually smooth, which makes the process highly suitable for integral (nonmodular) manufacturing and business operations.

As long as business conditions change at a slow, continuous pace, the coordination that this process enables, within a set of careful and yet precise moves, works. However, the new era of globalization and the digital revolution brought choppy, discontinuous change, requiring speedy decisions in which people had to "choose and focus." Dynamic shifts in strategy were the order of the day. In many cases, with the necessity to make decisions that were radical and sweeping, this brought huge distortions in previously harmonious internal arrangements. Moreover, often even even though top management became aware of the need for speedy decisions, all measures continued to be decided within the scope and timeframe of the one-village consensus framework. Such constraint inevitably resulted in only small-scale changes. Ultimately, the Galapagos syndrome was a byproduct of the one-village decision-making system.

The results of Booz & Company's thirteenth annual examination of CEO succession trends, which was released on January 17, 2013, and covered the largest 2,500 public companies according to market capitalization, perfectly illustrates the characteristics of this one-village mentality. These statistics show that 97 percent of Japanese corporate CEOs are internally promoted, a much higher percentage than in North America and Western Europe, as well as in the BRIC and other emerging countries. Additionally, 75 percent of Japanese CEOs have worked at only one organization, as compared with other countries where the figure lies between 7 and 20 percent. This study also suggests that whereas the global average age for a CEO is fifty-three years of age when they take up the position, the figure for Japan is six years older, at fifty-nine years. Furthermore, only 1 percent of CEOs in Japanese corporations are non-Japanese. In short, Japanese top management is selected from a rather small cohort of people. Such people can be expected to read any given situation from a position that is at once narrow and very much on the inside, which is to say that they will probably lack a global perspective.

Escaping from the *kaisha* model

As previously explained, many Japanese corporations faced difficult times in the 1990s. It is worth noting that in many cases the systemic problems were acknowledged and discussed. Japanese companies were still sending many employees abroad to the United States to study at top universities. These people gained exposure to, for example, the internet-related innovations that were starting to happen in Silicon Valley. Japanese companies were among the first to expand overseas operations into China. The issue of accelerating consolidation, for example in memory chips (DRAM) or in LCD devices, was raised at an early stage. Questions regarding the nature of these industries, how to leverage economies of scale, and how to take product design modularity on to commoditization were the frequent subject of debate.

Nevertheless, despite having a sufficient knowledge of the latest trends, corporate leaders were unable to propose any effective solutions that would define the necessary course to be taken for their organizations in the future. The causes behind this powerlessness were deeply rooted.

Many of the largest Japanese companies had become highly successful in the business environment that had prevailed from the 1960s to the 1980s. They had utilized their competitive advantages under the Japanese management system, or the *kaisha* model. Their business practices, systems, and regulations all arose out of this management model. *Lifetime employment, for example, was originally nothing more than a voluntary labor arrangement between employers and* employees practiced mainly at large companies, and had been designed to overcome a labor shortage during the 1960s. Later, court decisions made this practice the norm for most regular workers in any kind of company and instituted a form of employment for life. The dual-tier industrial organization comprised large corporations and small- to medium-sized enterprises. At the same time, a vertically collaborative system known as *keiretsu* (informal groupings of enterprises) grew and worked effectively to produce top-notch quality products with cost flexibility in the manufacturing sector based on vertical integration strategy model. The "main bank" system, which involved close long-term ties between corporations and single large financial institutions, worked for the financing of corporate activities and in providing oversight in cases of sudden underperformance. The government's rigid regulation policy served to further banking stability by promoting this main bank system.

For thirty years, this arrangement had functioned well: the key socioeconomic structures like managerial and labor practices, the industrial structure, and the financial system all worked together, reinforcing one another. In the 1990s, the system was already entrenched both at the macroeconomic and the microeconomic levels.

In short, the very success of Japanese business practice and culture up until that time served to place business leaders under a kind of curse – a psychological trap that became all the more difficult to escape in the face of a business environment that in the 1990s suddenly started to undergo rapid change. In addition, in many cases even if CEOs had summoned up sufficient determination to try to transform their companies, few leaders of conventional large Japanese enterprises would be able to implement drastic reforms – they would instead be likely to encounter great internal resistance. And even had they convinced their own organizations to change, they would still have had to face steep hurdles originating in the rigid social establishment. The Japanese industrial community became immobilized, completely trapped by the narrow confines of its own one-village mentality, which ironically had slowly enveloped it during the years of high achievement. And the first companies to suffer from the dilemmas arising out of changing business conditions were the major electronics companies – their business models and organizational nature made them extremely vulnerable in the new environment.

The Japanese companies that did not deal well with the new business environment usually either missed the chance to invest in growth opportunities because they were unable to abandon underperforming business units (such companies tended to be manufacturers of general electric devices); or because they pursued a power game, driven by frequent zero-based redesign of new products, which did not match their core competencies (semiconductor and large-size LCD TV manufacturers); or because they became overly fixated on the growth potential of B2C information technology devices, which were outside their core capabilities.

In contrast, the companies that came out in a better position in the lost decades consistently adopted a "choose and focus" approach in their strategy and instituted a strong CEO-based model in corporate governance, one that had been adapted specifically to Japanese corporate situations, synchronizing organization and corporate architecture with an internal workforce comprising regular, skilled employees who had been trained up within the company.

In the end, the most effective key to global competitiveness lay in adopting an appropriate corporate architecture, one that would suit the Japanese socioeconomic environment, and at the same time enabling swift internal strategic decision making.

Overcoming the curse

The Japanese companies that successfully dealt with globalization and the digital revolution fall into three groups. The first group comprised newly established companies led by their owner/founders – they include Softbank, Rakuten, and First Retailing. These entrepreneurial companies were (and are) comprised mostly of younger people, extremely flexible, and relatively free from the conventional practices of the old Japanese management system. Power is kept to a few, strong figures at the top, enabling swift strategic decisions to be taken, something that is essential in the digital revolution age.

The second group comprises small but globally excellent companies and niche top companies in manufacturing. These companies focus on their core competence and establish unique and strong strategic positions (typically taking more than a 50 percent market share) in the small- to medium-size market segment. Most of these companies are the business-to-business (B2B) players in mechatronics (a fusion of mechanics and electronics), or in the manufacture of component or specialty materials, where their core competence allows for technology accumulation based on long-term business experience. They usually have a close relationship with their customers. Their products are not so significant in the cost volume arena, but represent extremely critical components for their customers – and so suppliers rarely switch. Despite their relatively small size, they are not subcontractor companies who stick to supplying large domestic manufacturing companies, but remain independent, selling products to a customer base all over the world. Such companies include Hirose Electric Co. Ltd., a manufacturer of specialized connectors for mobile phones, and Mani, Inc., a manufacturer of medical and dental instruments. These companies sell their products on a worldwide basis and have attained a dominant position in their respective global markets.

The third group comprises large manufacturing companies like Komatsu, Daikin, and Bridgestone. These companies conducted reforms successfully – under strong leadership they overcame structural problems and implemented long-term managerial changes. They have evolved significantly, retaining their edge as Japan-based manufacturing companies and building strong positions in the global market – continually reshuffling their product lines and functional units in order to keep these positions in competitive markets. Their corporate governance is a hybrid of Japanese and American styles, and they are very internationally minded.

Some companies even in the problematic electronics industry, which is perhaps the most affected by globalization and digitalization, have demonstrated positive results. Hitachi, Mitsubishi Electric, and Panasonic all successfully adopted the "choose and focus" managerial approach and pursued reforms in their corporate governance systems. Importantly, they were strongly aware of their core competencies and organizational capabilities as old, large, and well-established Japanese corporations. Despite substantial economic losses suffered in their organizational struggles during the lost decades, they appear now to be applying and profiting from the lessons learned. The on-site/first-line capabilities of many Japanese manufacturing companies are still intact and remain at world-class levels. With the correct reforms in their decision-making processes, these companies should be able to reap tremendous benefits in the coming decades.

A case study: The struggles of Sony

The consumer electronics company Sony played a major role in the development of Japan's economy as a major exporter during the 1960s, 1970s, and even the 1980s. In the 1990s, however, its power seemed to dwindle, and it became known for its fading brand name. Its fall from dominance as a once-renowned electronics giant derives from a series of inappropriate decisions that relate to the company's business portfolio strategy and tardy adoption of digitalization solutions, despite ongoing efforts in corporate governance reform. Sony was still making financial losses in the late 2000s, and has yet to make a full recovery. Here I will concentrate on the problems directly linked to managerial issues and on the one-village mentality that contributed to its problems.

From its very beginnings, Sony was an atypical Japanese company. Originally founded by Ibuka Masaru, it made a name for itself by creating markets for new technological devices and "cool" products, which were sought after for their quality, functionality, and portability. When cofounder Morita Akio became president in 1971, the company was highly entrepreneurial and capable of making fast and calculated decisions – quite different from other Japanese companies at the time. However, in the 1990s, when the founding generation of executives retired, the company made some questionable decisions, aggressively expanding into new businesses – the entertainment media, financial services, electronic components (semiconductors), and chemical materials – and it became too diversified. The company lost the ability to define its own strategic focus.

Despite such mistakes, Sony remained a player during the early stages of the digital revolution in the 1990s. It introduced the PlayStation into the video game market and the VAIO brand in the PC arena. In 1995, Idei Nobuyuki, a Sony lifer since graduation from university, was appointed president, initiating a period of "salaried" top management. This was a typical Japanese management practice in which employees advance from their initial employment after university graduation and, in line with the internal seniority policies, potentially progress to a CEO position (usually in four- to five-year rotation periods) at about sixty years of age. Idei appears to have grasped the challenges facing Sony in an increasingly globalized world and the changes required by digitization, and identified three main issues that the company had to address. The first was to create and nurture strong leadership in the organization in the post-owner/post-founder generation. The second was to enable management agility and control – the company employed over 200,000 people and was a highly diversified, autonomous business with a global reach. The third was the problem of ossification that had clearly beset the company and the one-village mentality characterizing its internal relations – a problem that beset all old and well-established Japanese companies (and Sony was now one of these).

Simply put, Sony's management needed reform. It was quite clear that no company could survive in the digital age by keeping basically to the *kaisha* model with a few piecemeal adaptations and continuing to only depend on nonconfrontational and harmonizing planning among business unit heads for setting the corporate direction. Sony accordingly initiated a series of corporate governance reforms. The position of CEO was introduced into the corporate architecture. The company also decided to adopt American-style management practices – with power exercised through a top-down decision-making structure, with stronger executive power. The rationale for this was that the company now needed strong leaders to enable fast and decisive steering at the corporate helm.

When Sony initiated its corporate governance reforms in 1997, it was one of the first companies in Japan to introduce a mostly independent board and a system of corporate executive officers dividing the supervision and execution of tasks. In addition, a focus on value creation was introduced by implementing economic value added (EVA) models for measuring performance. Several of its publicly traded subsidiary companies were delisted. These dramatic changes frequently brought Sony into business media headlines as the pioneer in modernizing corporate governance in Japan. CEO Idei proposed a new vision for the company based on the key term of "regeneration" (rejuvenating Sony), making every effort to stimulate innovation and attract new customers, because young and old alike were now fascinated by digital technology.

Sony also adopted an American style of management and a new corporate vision, in the hope that – even though many on the corporate board were now external directors – it could resuscitate its fortunes and remain a player in the new digital age. Other corporations also thought that this was a progressive way to deal with the changing business environment and emulated Sony. In Sony's case, however, these reforms did not work well.

Sony's difficulties

The challenges Sony faced involved the very core of its organization. The new wave of innovation related to the digital revolution impacted most of its central businesses. The new Internet business wave favored much younger entrepreneurial companies led by charismatic founders. The company's last resort was to truly shake up things internally, and these changes demanded a shift in the strategic top-down decision-making process, which had already been made by Sony's American competitors. However, Sony's CEO did not have the same role and powers as his Western counterparts or the influence that Morita once held. The nature of Sony's organization, which began to resemble other Japanese competitors, did not allow this sort of adaptation.

Sony had fallen into the same trap as many other large and well-established enterprises. It was unable to keep pace with the internet age that thrived on the discontinuous and radical, spontaneous innovation of the B2C information technology sector.

Due to duplicate products and services, Sony's brand had become diluted and the company lost time in dealing within the internal chains of command. Its past successes led to the self-perception of superiority in terms of technology and products. Sony had become convinced of its principles of self-sufficiency and its corporate mentality was weighed down by its own bureaucracy.

Although Sony was looking for opportunities to utilize its technological prowess (even now Sony is acknowledged as an excellent innovation leader) in element technology as its competitive advantage in the digital B2C sector, it is not clear that any decisive actions were taken concerning how to deal with non-core and loss-bearing businesses in terms of reconfiguring the corporate portfolio. In the end, the company lost the opportunity to invest in growing businesses due to its inability to divest itself of its firmly entrenched, pathological Japanese-style decision-making behavior. Sony continued to keep its particular internal assembly process (equipment and workforce), despite seeing Western competitors flexibly adapt to changing trends in the assembly process. It was not long before the "Sony shock" occurred.

The "Sony shock"

Latent problems in Sony started to surface around 2002 when profit margins began to shrink, producing what was later labeled the Sony shock. In the light of the losses, Idei Nobuyuki, then CEO and chairman of Sony, turned the company's focus to restructuring and reducing redundancy. The biggest problem was not his initiatives, but the internal resistance that he encountered. He eventually resigned. In 2005, the company took a further measure to deal with the poor internal state of governance and appointed Sir Howard Stringer as CEO in an attempt to escape the trap of the one-village mentality.

This move improved the company's fortunes somewhat during the high consumption period prior to the world economic recession. Sony began shedding production facilities and other fixed assets, while laying off employees at various stages. Unfortunately, fundamentally nothing changed. The problem was that no one wanted to make unpopular and drastic decisions such as divesting the company of the loss-bearing TV and game businesses, or making the radical shift to the fabless business model. It seems that not even a non-Japanese CEO could overrule the divisions that arose from the bottom-up decision process. As a consequence, Sony tried various options to adapt to the digital revolution, but these did not always deliver the desired gains. Before long, the company had merely become another old and large corporation in which the decision-making process had been altered superficially but at heart remained what it had always been and driven by the same operating principles as any other ordinary Japanese company.

Another factor behind the organizational inertia was the system of hiring of employees. In its owner/founder management days, Sony had the same human capital acquisition practice as most American venture companies and acquired many of its key leaders from outside and from untraditional career tracks. In fact, Sony had a considerably diversity within its management layers in the 1970s and 1980s because, unlike its competitors, it was still an entrepreneurial company and strove to attract the best talent from the outside. Ohga Norio, Sony's CEO prior to Idei, had been an aspiring opera singer before joining the company. Unfortunately, this practice of acquiring leaders from untraditional career tracks lapsed over time and the company began systematically hiring university graduates and offering lifetime employment. The results were typical of most of Japan, Inc. Despite having a foreign CEO, the majority of its outside directors were corporate officers who had been lifelong Sony employees since graduation from university. This naturally increased the inertia of the *kaisha* model.

Sony's problems and struggles

Despite the transformation initiatives since the mid-1990s, many superficial discussions took place in which top managers were held responsible for the failure to innovate because they did not have engineering backgrounds. They were blamed for the fact that management provided only a conceptual vision, which was far removed from the everyday operations of the company. However, I believe that such discussions did not get to grips with the real problem. The key issue was the nature of people in the organization of the old and large Sony. The late founder of Apple, Steve Jobs, did not offer specialized engineering expertise to his company. When, after leaving Apple once, he returned to the company, his grand vision and his charismatic (some might say dictatorial) leadership were enough to take Apple on to eventually dominate the field with portable audio devices and the smartphone business.

Would it have been possible for Sony to come up with an effective strategy in response to the iPod and the iTunes ecosystem created by Apple? Sony had the technical capability; the main issue was how to establish similar integrated internet-based services. Organizationally, however, it was an entirely different story. Apple was a small, flat, and simple organization with a young and charismatic leader. Sony was a huge, hierarchical, and complicated group of business units with a "salaried" CEO at its helm. The key problem was how to bring the various parts of each business together to achieve the best fusion of capabilities in hardware, software, content, internet access services, and payment processing. Such a conglomeration also required an extremely fast response time, as the new digital age demanded agility. Overcoming organizational torpidity was the greatest hurdle to successfully countering Apple products and services. And the main problem was that the new game was not designed for large, diversified, decentralized, and old organizations. Apple, Google, and Facebook were all young and small, a model that will always win in a game in which radical and fast-moving innovation is required.

Core issues and challenges ahead

Sony's issues were not just related to management and corporate governance. Transforming Sony involved addressing its corporate culture, organizational habits, and the behavior of its managers and employees. In many ways this poses an even greater challenge than strategic change, as it takes time to catch up in order to coordinate the synchronization of new systems and people. Sony's management should have tried to stay more aware of what was happening in the organization. It should have spent more time and energy in encouraging not just strategic change but also cultural and behavioral transformation at the lower and middle layers of its companies. One might argue that Sony's main business domain did not allow for such a time-consuming approach, but this was the reality of Sony in the early twenty-first century. Haste does indeed make waste.

Should Sony have attempted to redefine its business portfolio based on its core competence and adopted the "choose and focus" strategy, despite its lumbering and massive organizational structure? Should it have brought in young and charismatic talent to resuscitate itself? This is what many middle-aged Japanese were wistfully wondering, as they recalled the original founders of Sony, who were so innovative. Opinions on the subject remain divided.

One U.S. company whose foundational story is similar to that of Sony and that faced a similar dilemma in the 1980s was General Electric (GE), a company founded by the king of inventors, Thomas Edison. Under Chairman and CEO Jack Welch, GE chose not to pursue the romantic path of innovation. Instead, "Neutron Jack" made GE focus on segments – jet engines, power generators, medical devices – the technological competitive edge in these segments was "integral" rather than "modular," "cumulative," or "zero-based." But GE was not the only company to transform itself. Similar transformations happened at other technology giants such as IBM, Intel, and Microsoft. In Japan, Komatsu, Bridgestone, and Hitachi also overhauled themselves. The success of these companies demonstrates that first identifying organizational capabilities and then linking them to specific business strategies can offer large and well-established corporations an effective method for change.

If Sony had done this, it would have had a huge effect on the rather romantic image of the company in the imagination of the public. In addition, the question remains as to what extent it could effectively leverage its nature as an established and large organization and coordinate it with a focus on strategic domains, where its core competence could be more effectively utilized. Such a move requires a drastic change of corporate architecture and requires time.

Sony still has the option to bring in younger leaders and to pursue innovation, in keeping with what it did in the days of Ibuka and Morita. Such an achievement would provide a brilliant success story in management history if Sony were able to combine a reliance on technology accumulation and B2B focus, in addition to the option of challenging discontinuous innovation serving the B2C segment, as no other company managed to pull this off before. As such, Sony is at a crossroads and whatever option it chooses to follow, it will not be easy. If Sony manages to utilize the experience it has gained over the past twenty years and fundamentally reshape its own organization in its corporate values, behavior, habits, and decision-making process, then the young Hirai Kazuo, newly inaugurated as CEO in 2012, and his team may have a better chance to put the company back on the right course.

Conclusion: The end of the curse of Japan, Inc.?

In this chapter, I have examined trends in the lost decades that showed how the traditional corporate model in Japan was unsuited to the new world of globalization and digitization. Globalization joined up markets all around the world, making the traditional view of individual, separated markets completely outdated. The digital revolution created a new era in which radical and disruptive innovation flourished. Its ever-changing nature forced companies to move away from core capabilities that had been shaped through technological expertise and the accumulation of know-how, typical for corporations established on linear and continuous innovation. The Galapagos syndrome had driven Japanese product development to extremes, so that many Japanese companies were making highly complex products that could only suit narrow markets; it had also narrowed the country's ability to see what was happening in the wider, newly expanding global market. A strong bias toward the domestic market had sidetracked the corporate strategic mindset, which remained too focused on high-price/high-quality solutions and products without trying to challenge and proactively penetrate emerging markets.

The inability of Japanese companies to cope with globalization and digitization was deeply rooted in the organizational fabric of Japanese corporate management. At one time, the codes of practice in Japanese companies were supremely efficient – but they were now long past their expiry date. Unfortunately, most of the Japanese business community remained unaware of its lack of capacity. Those companies that did manage to initiate transformational changes fall into two categories: ones that recognized their outdated nature and successfully transformed themselves by utilizing organization-specific capabilities, and ones that grew new businesses to a sustainable scale under the direction of their founders.

While Sony was relatively young, it was able to pit itself against older, more established Japanese electronics giants and win. During the years of the lost decades, however, when the company had gained an established position and was run by "salaried," lifer executives, it had to compete with new, global technology champions such as Apple and Google. These competitors attracted a much younger generation of engineers and product developers, and they also had strong visionary leaders who could execute more agile and dynamic strategic decisions through a top-down approach.

Managers at Sony and other Japanese companies did become conscious of the mismatch between their corporate strategy and management styles and the new environment. They tried various measures – introducing a system of independent directors, for example, and instituting company and performance-based evaluations. However, these attempts failed to address the problems deeply enough, resulting in patchwork corrections that never took systematic or consistent root, and the gap between organizational behavior and capabilities grew. The failure can be compared to computer users who do not wish to change their old operating systems but still try to upgrade their computers and use the latest applications by buying new hardware components. Piecemeal improvements mean the computer will not run well and there is actually even a greater likelihood of errors or failures. Changing the operating system in an organizational management structure is not easy. Integrity and consistency also have to be installed into the system: all informal relationships have to be thrown out, power relations that have grown up over the years, with accompanying assumptions, have to be dismantled, and attitudes of employees and stakeholders reset. The enormous and yet delicate managerial effort necessary to accomplish all this requires considerable time. The longer the old operating system has been in place, the harder it is to overcome old and entrenched behavior. This is possibly why such transformations that did occur over the long lost decades were so slow in coming.

The lessons of the lost decades and the struggles that many Japanese companies went through have universal relevance. Many companies in China and other Asian countries will soon face comparable issues, once their founders retire and new management comes on the scene. Continued success inevitably brings the risk of inertia taking hold. In any successful organization, internal and external stakeholders will have vested interests and will want to prioritize harmony and the status quo at the expense of rational, clear-headed adjustment to external change.

I will end this chapter on a positive note. I firmly believe that Japanese corporations still possess the capacity to acquire technical expertise and business know-how, as it is one of their greatest strengths to focus on the long-term horizon and continuity in product development. Japan's current problems, which include an ageing population as Seike Atsushi describes in Chapter 1, and a looming energy crisis resulting from the Fukushima accident as outlined by Kitazawa Koichi in Chapter 7, will not be easily solved. But these challenges in fact have the potential to offer fantastic opportunities for the private sector and could lead to an expansion of technologies and business models in, for example, energy management, medical devices, and services for an ageing society – fields in which all the developed economies, including those of China, India, and Russia, will need products. Japanese corporations have been given a precious opportunity to make an early start in securing a potentially highly advantageous market position.

To move back to the central theme of this book, I support the argument that demographics will play a decisive role in the direction that Japan chooses for itself in the future. In Japan, the first baby-boomers were born in the period from 1947 to 1949. This first post-war generation was nurtured in an environment based on traditional Japanese management practices and a decision-making process that reflected a one-village mentality. All this needs to change. The key to improving Japanese corporate governance and resolution processes lies in overcoming the inertia and apathy regarding alteration of the status quo. Japanese companies now need to start executing a top-down approach and to stop relying on middle management in making their strategic decisions.

The baby boomers in Japan are now reaching retirement age. The departure of such a large number of people will open up spaces in the corporate ranks. These leadership positions will more than likely be taken up by younger people who have a more individualistic set of values and a more results-oriented approach. The change of guard has the potential to lead to a break from the traditional one-village mentality that has characterized Japanese corporate decision making. I hope that the present upside-down pyramid composition of companies, with serried ranks of older people occupying the top positions, will be corrected, and excessive labor-related fixed costs will be reduced, and that it will become easier to escape from the old *kaisha* mindset.

For those old and well-established enterprises that have passed into the post-disruptive/nondiscontinuous innovation phase, it is essential to realize how important it is to bounce ideas off multiple corporate functions to obtain fine-tuned integrated outcomes. This part of the integral or hybrid (integral and modular combined) business approach needs to be emphasized as a key organizational core capability. With an adequate corporate architecture in place to encourage strategic decision making, this focus on continuous innovation could be leveraged as an advantage and utilized as a company's own core competence.

Looking at Japanese companies who have succeeded and those who have failed, we can extract some important clues for success in finding sustainable business approaches. There are key elements in enhancing strategic decision making and execution capability, driven by rationality and speed: the importance of keeping a strategic focus on core competence in the new and global competitive environment, and disregarding ungrounded or superficially competitive advantages or market fads; the importance of creating the right conditions for and nurturing strong leadership (this last includes instituting new systems to improve human capital development, CEO selection and empowerment, and the governance structure); and the importance of creating a globally diverse organization in terms of personnel and management style.

The good news is that the keys or clues all entail changes in attitude or focus toward strategy to be made by the upper echelons of the Japanese corporate community, that is to say the people at the very top. This means that most Japanese companies can duplicate this success. It also means that the fundamentals of the Japanese industrial community in terms of the basic caliber of the employees and their morale remain solid and competitive. All that is needed is for management to adopt the correct strategy and correct focus.

The years after the 1990s have seen many changes take place in Japanese business with significant revisions in corporate law, the bankruptcy code, and labor laws. Subinstitutional systems like the main bank system have less hold, and financial regulation policy has also been completely overhauled. Japanese banks are now much more focused on their own survival. The control exerted by the traditional main bank system is now limited by a new regulatory environment and the current health of cash positions on corporate balance sheets. The employment of external directors is also becoming a more common practice and is having an effect on corporate governance in Japan.

Obviously, obstacles and challenges remain, but they are steadily being dealt with. Even among the major electronics manufacturers, traditional and large companies are adapting management systems and strategies under the direction of visionary leaders. New ventures are appearing, based on disruptive and nonlinear innovation, and there are clear signs of a new potential for much more global players. All is not necessarily lost in Japan. The two lost decades, twenty years of struggle, may, in the end, bear fruit.