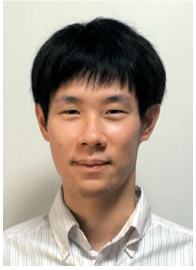
# What Is Needed to Improve the Nature of Large Companies?



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## Main Points

- Economic policies are an important aspect of national security. As we have frequently seen in recent years, the effects of economic sanctions differ significantly depending on the competitiveness of companies in one's own country.
- Global inflation means that the benefit to Japanese companies from low interest rates will be increasingly limited. The competitiveness of large Japanese companies also affects exchange rates and the current account balance.
- A higher level of multilingualism, going beyond the use of English alone, will be advantageous when competing with other global companies in consumer countries, primarily in Asia. Learning local languages will also have the benefit of enhancing communication with head offices in Japan.
- The fact that large companies have accumulated huge amounts of cash over the years means that their competitiveness will diminish significantly over the long term. They need to reinvest and pass on the cash as wages.
- The evaluation of government policies is more effective if failures as well as successes are verified objectively and quantitatively. The quality of policy evaluation hinges on progress being made in information disclosure.

## National Security & Japanese Companies' Competitiveness

The end of the 1980s saw the end of the Cold War and major moves toward globalization, and one of the biggest changes this brought about was that companies became increasingly independent from nation-states. The 2008 Global Financial Crisis and the 2022 war in Ukraine have shown, however, that the relationship between regional nation-states and corporate activities cannot be severed even if it is attempted.

Since the beginning of the 21st century, various countries led by the United States and Europe have imposed economic sanctions on Iran, Myanmar, and Russia. These sanctions have accelerated moves by companies based in the imposing countries to withdraw from the markets of the sanctioned countries. With today's global diversity of values, it has become necessary to focus on the relationship between companies and nation-states. The relevance of nationality in corporate activities can be seen as gradually diminishing, but when a government seeks to force companies to withdraw from designated countries, the question of whether a company owes allegiance to the country in which it is headquartered becomes decisive.

Even if we simply say economic sanctions use a country's companies, we need to understand that the effect of the sanctions will differ decisively depending on those companies' unique characteristics and competitiveness. Let us consider the example of Japan using Japanese companies to impose sanctions on Country A. If Japanese companies have a large share of the supply chain in Country A, Japan's economic sanctions will have a huge effect. If Japanese companies become unwilling to supply intermediate goods, it will become difficult for many companies in Country A to produce and sell their products. Conversely, if Japan is subjected to economic sanctions imposed by Country A, companies in Country A will have difficulty maintaining a presence in the Japanese market. If there are few companies in Country A with a significant position in Japan's supply chain, the effect on Japan's economy will be negligible. On the other hand, if Country A's companies have many, various transactional relationships with Japanese companies, the effect will be completely different. If non-Japanese companies increase their share in Japan's markets beyond current levels, a major risk arises in that these companies may withdraw from Japan in the event of an emergency. At the same time, Japanese companies having large shares in overseas markets strengthens Japan's security card. Companies' competitiveness becomes a condition that significantly restricts that country's security strategy.

Looking at the period from the second oil crisis in the 1970s to the 1980s when major countries with advanced economies recorded economic growth, intense trade friction emerged between Japan and the US and other countries, but the competitiveness of Japanese export-oriented manufacturers in particular has gradually been declining since the 1990s. In some industries like automobiles and shipbuilding, Japanese companies have the majority of the Japanese market as well as large exports, while in areas like steel and semiconductors, Japanese companies had large shares of the global market in addition to in Japan, but today there are cases of non-Japanese companies making inroads into the Japanese market. In addition, in new industries like software, there are many cases where reliance on Japanese companies was low at the outset and continues to be the case today. If this trend does not change for the next 10 or 20 years, it is certain that Japan's degree of flexibility with regard to security will decline significantly.

## Changes in the Environment for Large Companies

In the early 2010s, business results for major Japanese companies looked favorable in accounting terms, but as inflation began to appear in major countries for the first time in some while from around the spring of 2021, there have been signs of major changes in the environment for large companies. These companies have been able to maintain their traditional Japanese management and employment systems because for roughly 30 years they were able to procure funds at low rates against a backdrop of loose monetary policy. In addition, Japanese companies had fewer production bases in consumer countries than they do today, and easing monetary policy has also put downward pressure on the yen.

If Japan were to end its monetary easing, large Japanese companies would face investment risks that they have not had to address for close to 30 years. We now need to realize that the problem of the huge amount of government bond holdings, which has been a concern for a long time but has not had a noticeable adverse effect on financial markets, could surface in an instant going forward. It is better not to expect that the country can return to its policy of ultra-low interest rates at any time.

Over roughly the past 30 years, Japanese companies have been moving production bases to consumer countries. This is intended to reduce shipping costs and make it possible to respond flexibly to local demand. As a result, a weak yen does not generate profit to the same extent as in the 1990s. This does not mean, of course, that there are no positive elements, including manufacturers that have remained in Japan and industries including tourism and services that need so-called inbound demand, but it is true that this effect is less than was previously the case.

Foreign exchange factors and current account balances are also important when considering economic security. Continued large current account deficits mean that foreign currency flows out of the country, making it difficult to intervene in the foreign exchange market. If it becomes difficult to prevent its own currency from depreciating, it becomes more difficult for a country to implement monetary policy that aims to stabilize prices. The degree of flexibility in fiscal policy, which only plays a role in the public sector areas of social security, industrial development, and education, essentially decreases as well. Although their standards of living and country size are completely different from Japan, Turkey, Sri Lanka, and Pakistan are countries that have not introduced effective monetary and fiscal policies this year (2022) despite directly facing inflation. What these countries have in common is that their current account deficits have become chronic, and acquiring goods from overseas is becoming difficult.

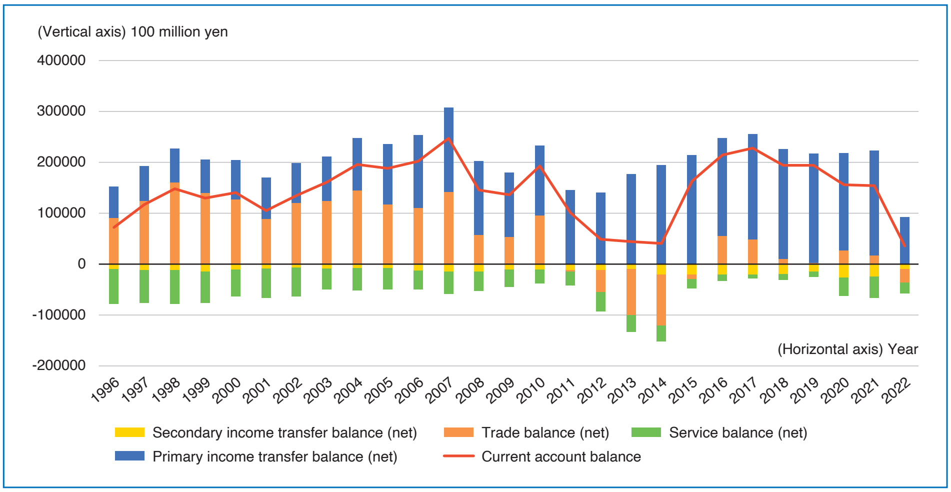
*Chart 1* shows Japan's international balance of payments since 1996. We can clearly see that the trade balance has trended negative since the early 2010s, but at the same time the current account balance has been positive, propped up by the income transfer balance. In the past, Japan's positive current account balance was supported by the trade surplus, but this has gradually fallen since the 1990s. Despite this, Japan has been able to maintain a current account surplus because of the large income transfer surplus from gains on Japanese individuals' and companies' overseas investment, and this portion remains. For government functions to be sufficient, it would be preferable to keep the trade deficit to a minimum while maintaining the income transfer surplus. Now, while the income transfer balance is being maintained, is the last chance for Japanese companies to increase their competitiveness.

## Response to Globalization

In various studies of Japan's economy, almost all cite the falling

CHART 1

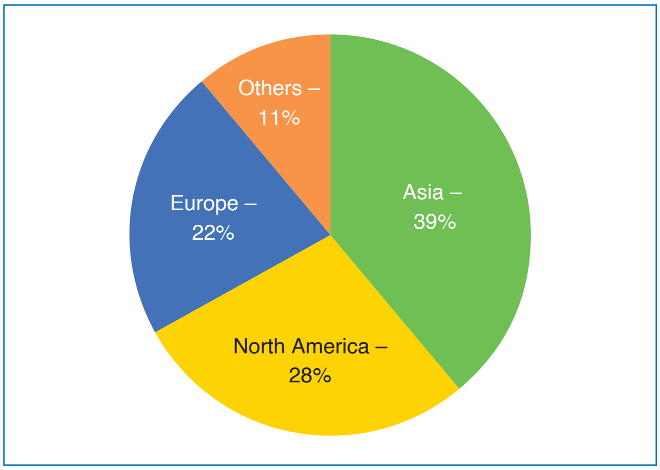
### International balance of payments




*Source: Bank of Japan's Time-Series Data Search website*

CHART 2

## Breakdown of Gross Domestic Product by region (2021, US$)




*Source: International Monetary Fund database*

birthrate and aging population as a reason for the decline of Japanese companies. This is because in addition to the contraction of the working-age population, the latent volume of end-use consumption – the most important element of demand for companies – will decrease going forward. It is quite difficult to expect domestic markets to show continuous growth in demand.

Looking overseas, on the other hand, developing countries in Asia account for more than half of the world's population, and regions with latent consumption unlike anything seen in the past are emerging one after the other. Many readers are likely to be surprised that, as shown in *Chart 2*, Asia already has the largest economy in terms of gross domestic production by region. The days when the G7 countries, primarily the US and European countries, accounted for the majority of the global economy are increasingly in the past.[i] Anyone can see that the amount of earnings that can be obtained from these overseas markets offers a shortcut for enhancing Japanese companies' competitiveness.

Policy discussions in Japan on how to respond to globalization in recent years have put English-language ability at the forefront. We are seeing English-language support in government administration, companies adopting English as their official in-house language, and stepped-up hiring of English speakers. This alone is insufficient, however, for making inroads into large consumer markets. It will take time to enhance human capital in terms of language-related reforms. Countries that are more advanced in terms of English-language capabilities (including regions where English was originally the native language) are proceeding to move toward multilingualism just as Japan is completing its English-language response capabilities, and therefore it is quite possible that Japanese companies will find themselves to be in no better position in terms of competitiveness.

Even though language education is expanding around the world, it is not easy to change the fact that there are only a handful of countries in which the majority of the population is able to understand English at an advanced level. This is especially true when we talk about understanding a foreign language with the same level of intuition as one's native language. In a majority of regions around the world, the people who are comfortable using English tend to be those with higher incomes (and in large cities in particular). At the same time, the importance of consumption by the middle- and lower-income classes in countries including the Asian countries mentioned previously is skyrocketing as their economies grow. People other than those with high incomes need to be approached in the local language. English-language services and capability are taken for granted in competition among large companies with increasingly international workforces, but going forward gaps will emerge based on whether companies are able to approach groups who do not use English. This strategy could be called meticulous globalization.

The region from South Asia to Southeast Asia and China, with its huge population and the world's highest economic growth rates, is particularly important for Japanese companies. When Japan accepts immigrants and foreign workers, this region is likely to the source of most of those people.

Making inroads in consumer markets is not the only benefit from multilingualism. To have quality communication between overseas subsidiaries and affiliates and the head office in Japan, it is clearly desirable to have some staff who are proficient in the local language. Research in management and management history shows that for many years Japanese companies have often tended to have more Japanese staff in junior management positions at overseas subsidiaries and affiliates compared with the American and European staff at American and European companies. This is superior in terms

i As of 2021, the G7 economies as a whole would not even account for 50% of the world's economy. Moreover, in purchasing power parity (PPP) terms, which gives a more accurate sense of economies in terms of economics, the GDPs of many emerging market countries become even larger. According to Deaton (2014), it is actually better to look at the size of economies in terms of PPP-based GDP. At the same time, he also points out that there are significant differences in the ways the numbers used in PPP-derived GDP measurements are obtained, resulting in large fluctuations.

of facilitating close communication with the head office in Japan. Even though it is rather difficult to achieve, an organization with Japanese staff who understand the local language in relatively junior management positions at overseas locations will have significant strengths.

To date, discussions about internationalization and the issue of immigration and foreign workers have only looked at the issues from the receiving side. Frankly speaking, it is from the perspective of "Which countries' markets and workers will Japanese people choose?" However, if we approach this from the perspective that many countries including China and India, which are experiencing economic growth, are facing population declines,[ii] the discussion becomes entirely different. With countries around the world looking to attract human resources from other countries, I would like to look at this from the perspective of "What can Japan do to be chosen by other countries?"

## Ways of Using Surplus Resources

Today, the financial position of large companies is significantly different from that at small and medium-sized companies. Certain large companies are able to record very large internal reserves on their books. Moreover, we should look at the fact that these internal reserves have been maintained for more than 10 years.

Having large internal reserves is often criticized as meaning that wages and reinvestment are low. I believe, however, that this criticism is based on a misunderstanding in which internal reserves are being confused with a company's cash assets, which is incorrect. In accounting terms, internal reserves are called retained earnings, and correspond to net assets minus share capital and capital surplus. The important point is that retained earnings (internal reserves) are not limited to cash, and also include equipment and structures.

During the 1970s and 1980s, Japanese companies, based on Japanese-style management, had large internal reserves and carried out vigorous capital investment, and this created additional economic growth.[iii] Apart from internal reserves, companies distribute earnings as dividends to shareholders. If these dividends are large, internal reserves become less. Traditionally, having large internal reserves meant that dividends were low and earnings were passed on to employees as wages or reinvested for the company's future. During this time, Japanese companies had large internal reserves and kept dividends low to make large amounts of reinvestment.

There are two main criticisms of internal reserves. The first is that even if assets are buildings and other capital investment, it would be better to reinvest or distribute them as wages to employees. In other words, this is wasteful investment. Even if the amount of capital investment itself is not the problem, it would not be unusual to question whether the capital investment is really contributing to enhanced competitiveness.

The second is that the cash assets portion of retained earnings is not being used for wages or reinvestment and is in fact surplus assets. Generally speaking, if a company holds large amounts of cash internally, this will help to avoid default in the event of a financial crisis or major shortfall in demand. It may be natural for cash assets to swell immediately after a financial crisis, but having this go on for an extended period, or increase further, presents the following problems.

Compared with before the 1990s, many companies have become able to procure funds in capital markets. It can also be said that it was easier than had previously been the case for management to take on risk. Prior to the 1990s, only a very few companies that already had large market shares were able to issue bonds and otherwise raise funds from capital markets, but in recent years rather small companies and startups are using the equity market and bond market.

We can see why, having experienced the nonperforming loan problem that lasted from the 1990s to the early 2000s and the 2008 Global Financial Crisis, large Japanese companies wanted to improve their financial position in case of an emergency. However, holding large amounts of cash internally becomes a major negative factor in terms of future growth. When capital markets were performing well while being supported by financial easing by the central banks of major countries, it was possible to take on risk and invest, and they should have used their cash for reinvestment. The argument is also made for changing the tax code to reduce internal reserves, but the important thing is how to discourage companies from hoarding cash

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ii Since 2020, there has also been a clear trend of declining birth rates in Western Europe and the United States, which have done a better job than South Korea and Japan in controlling their declining birth rates. (World Bank website).

iii Japanese-style management and the Japanese-style employment system, as represented by lifetime (long-term) employment, seniority-based wages, and company-based labor unions, are the management organization model typically seen at large Japanese companies. Some people agree with Mito, Ikeuchi, and Katsube (2011) that maintaining the corporate organization is the most important principle, and that these three features were chosen as the most rational way to achieve this. In addition, even though there are various views regarding when this system took root in Japan, there appears to be a consensus that these three features were most typically seen from the period of high growth to the 1980s.

internally.

In addition, in recent years large companies have been criticized for using too much of their earnings for dividends and other returns to shareholders and not enough for wages and reinvestment. Increasing dividends to shareholders is useful over the short term for securing funds by making the stock look attractive. Over the long term, however, the most important thing is to secure a superior workforce and increase reinvestment so that the organization can address growth areas. It has been pointed out that after a period of high growth, large Japanese companies have low dividend payout ratios, but since the beginning of the 21st century dividend payout ratios have been rising.

In addition, in recent years people around the world have become increasingly interested in businesses that emphasize sustainability based on things like the Sustainable Development Goals.[iv] Businesses that take into account issues like environmental issues focusing on climate change and gender equality in particular tend to be favored by investors. This trend is especially clear in Western Europe and the US. Today, many companies are expected to act in ways that run counter to conventional economic rationality, namely economic stability and security, and sustainability. We frequently see companies and other organizations make declarations that highlight sustainability, but there are still few cases in which actual management in Japan has significantly changed how it allocates internal resources. It would actually be preferable for large Japanese companies to participate proactively in presenting new values in countries around the world.

## Transformation of the Employment System

Large companies in Japan traditionally have had seniority-based wages, lifetime employment, and company-based labor unions, meaning that corporate organizations operate in ways that contrast with the employment systems in countries like the US. This model, known as the "Japanese-style employment system," became widely adopted by large companies during the period of high growth following World War II. The extremely strong competitiveness of export-oriented Japanese manufacturing companies meant that the strengths of the Japanese system were highlighted in academia during the 1970s and 1980s.[v] As Japan's economic growth rates have slowed significantly since the 1990s, however, increasing concerns have been raised regarding the sustainability of the system that was maintained for more than 30 years. When comparing it with the "job-based employment system" that is typical in the US today, it is dangerous to consider the Japanese system to be unconditionally inferior. Nevertheless, I would like to show that, compared with the high-growth period when the Japanese system took root, the merits have diminished and the demerits have increased.

During the high-growth period when the Japanese-style employment system spread, there was a strong sense of encouraging employee retention. Until the 1960s, there were labor shortages, in cities in particular, and the ratio of job openings to job applicants was extremely high. This meant that companies had difficulty attracting workers. In recruiting workers, the system promised wages for a long period of time and meant that workers' wages would rise the longer they stayed with the company, incentives for workers to choose a large company that were typical of the system. In addition, enhancing skills that are useful at one company to create company-specific skills is cited as another strength of the Japanese system.[vi] Japanese companies tend to hire new graduates as a group and then train them in-house to develop workers with skills that specifically fit the company.

On the other hand, this system has major harmful effects when a company boldly attempts to enter a new industry. The skills required differ markedly from past skills, and internal training requires significant time and expense. Retraining older workers and managers is particularly difficult. A job-based system in which workers actively move from company to company is more advantageous for industrial transformation.

Transforming the Japanese-style employment system will mean reforms that at least temporarily inflict major pain. In addition, I would note three points of caution. The first is the change from seniority-based wages to wages based on the work a person does. Whether or not the concept of the same wage for the same work takes hold will significantly affect labor market mobility. The second is the expansion of the safety net from the time a worker leaves their company until they are hired by another company. A weak safety net will make it difficult for workers to move to different industries. The third point is the emphasis on industry-based labor unions. The Japanese system operates on the logic of the "company," while a

iv There are two significantly divergent opinions as to why this type of investment is desirable. One is that even though profitability is the rational choice, investment should disregard this rationality given the importance of these problems. The other is that if one takes a long-term investment perspective, the importance of climate change will be recognized to a greater extent than was previously the case, and this investment policy is therefore the most rational.

v The most famous of these is "Japan As Number One," written by Japanologist Ezra Vogel, presumably for an American audience.

vi Koike (2005).

job-based system operates on the logic of "work." This will affect the negotiating strength of labor unions, which will therefore need to change accordingly.

I believe that timing is the most important factor when transforming employment systems and management systems. These transformations need to be pursued when unemployment rates are low and the financial environment is favorable. Forcibly implementing transformation during a recession when earnings strength has declined will only result in wage cutbacks, leading to an adverse cycle in which consumption also falls. It is easier for companies to carry out major organizational transformation when they have leeway in their financial position.

## Necessary Perspectives in Verifying Policies

All policies entail PDCA (Plan – Do – Check – Act). Many policies may give the impression of problems being identified at the execution and improvement stages. Looking closely, however, we can see that many projects have problems caused by things like an absence, leniency, or misunderstanding in the policy evaluation that goes unaddressed. Policymakers do not want to hear evaluations of policies that do not succeed, meaning that the evaluation itself may be done with a spirit of hesitancy. In addition, at times like elections, voters think of policy evaluations as "things of the past," which means they do not carry much weight.

Policy evaluation is indispensable, especially for policies that do not succeed.

It is not unusual for an evaluation made immediately after a policy is announced to take on a life of its own. In these instances, it is often the case that the policy's evaluation is only somehow remembered by the people involved. This article does not deny the role of involved parties' recollections in policy evaluation, but looking at policymaking and decision-making in Japan today, we can see that objective evaluation, and especially after-the-fact quantitative evaluation, is lacking.

It is bound to take time to have the basis for decision-making in place and be able to make an objective evaluation. For example, it takes time to prepare data for policy evaluation. To facilitate objective, quantitative policy evaluation, the following three items should be kept in mind.

The first is to expand the divisions that gather and put together the statistics and other data related to the policy. Even if the survey subject is the same, the meaning of the statistics can differ completely depending on how useful the questions are. Therefore, this should always be done by specialists.

The second is to incorporate outside perspectives and opinions. Proactively disclosing information is the best and fastest way to incorporate objective information from an outside perspective in a natural way. If a large amount of information is disclosed, it is natural that this will attract outsiders and to a certain extent will lead to an aggregate objective evaluation. It is important, however, to ensure that the data is collected and released in a user-oriented format. Japanese government statistics are not necessarily far behind those of other countries in terms of volume, but there is a major gap in terms of the methods and formats in which they are released and in the ways they are used, which is very unfortunate.

In considering the use of data, several items for improvement come to mind. The value of data deteriorates significantly if the method for collecting statistics or the questions used frequently change. This is because in many cases, the data only has meaning after it is compared with historical data. There is also still the issue of protecting personal information, but there is no question that proactively disclosing individual data further raises the level of policy evaluation. With society as a whole recognizing the importance of data analysis, we would hope that the government would take the lead in demonstrating models for information disclosure. From the perspective of economic security as well, the difference in usefulness between policy evaluation using data and materials from one's own country and evaluation that relies on overseas cases cannot be overstated.

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