

A

Historical Overview

By Goto Akira



Recently the word *keiretsu* has appeared in U.S. newspapers and magazines and is becoming part of the English language, along with *honcho* and *sushi*. This increased attention to *keiretsu* reflects the current international dispute over the closed nature of the Japanese market. There also has been growing interest in Japan's economic development as well as its market economy.

Having lowered governmental trade barriers that included tariffs and quality certifications during the '70s and '80s, Japan now has one of the lowest tariff rates in the world. However, foreign companies and governments that still have difficulties penetrating the Japanese market, now the world's second largest, have been focusing more on Japan's business practices. It is within this context that *keiretsu* has come up. The close-knit integration among domestic companies is being viewed as one of the primary obstacles preventing entry of foreign companies (including direct investments) into Japan's market.

Some people, however, see the close and sustained business relationships between Japanese companies positively as a source of the high competitiveness of Japan's auto and electric/electronics industries. *BusinessWeek*, in a recent special edition, reported how some U.S. companies are emulating such corporate relationships. Even U.S. economists continue to argue whether Japan's inclination toward low imports, especially manufactured goods, can be explained in general terms (scarce natural resources, abundant labor and capital, and geographical distance from the West) or whether little can be explained in this way and so should be ascribed to the closed nature of the Japanese market as a result of *keiretsu*. Some people see *sushi* as simply a bite-size piece of raw fish while others see it as an exotic and fashionable cuisine.

As for *keiretsu* there are also two

apparently contrasting views—some see it as an exclusive, reciprocal connection between companies incompatible with American society, its culture and its antitrust laws, while others find it a source of competitiveness for Japan's manufacturing industry.

This essay will try to organize the various keiretsu arguments in terms of what they mean as well as the historical and economical background. Keiretsu is not clearly defined in academic terms and its meaning often differs depending on the user, further complicating the issue. Thus it is necessary to clarify the meaning before discussing it in a wider context, providing a solid starting point for constructive arguments.

Breakdown by type

As I mentioned above, keiretsu is an ambiguous concept compared to, say, the GNP or the unemployment rate, which are clearly defined in economics. The term is used to indicate certain aspects of the way Japanese companies relate to each other, but people give different significance to it and some economists even deny the validity of the concept itself. Generally speaking, in recent arguments, the term has been used to indicate three types of corporate integration. First are the groups consisting of major corporations operating in various industries and these are specifically called horizontal keiretsu. The second type includes the groups consisting of a major manufacturing company and its subcontractors, known as vertical keiretsu. Third are the groups consisting of a manufacturer (or possibly a company in another industry) and its distributors and retailers, called distribution keiretsu.

The first type, consisting of companies in different industries, is often called horizontal keiretsu as mentioned above, but strictly speaking, the term is used to indicate a corporate relationship within one industry. Although it would be more accurate, therefore, to call it "conglomerate keiretsu," I will follow the customary usage in this article. Six groups are typically representative of horizontal keiretsu: Mitsui, Mitsubishi, Sumitomo, Fuyo (Fuji), Dai-Ichi Kangin



The Yasuda and Asano zaibatsu, and the Nissan, Mori and Nezu concerns, all independent enterprises before World War II, merged to form the Fuyo group. Now, Fuji Bank (pictured above) is the core financial institution of this group.

and Sanwa. Of these, the first three have their origins in pre-World War II conglomerates called zaibatsu. (The Fuyo group could also be included with the first three because its core company, Fuji Bank, was once the Yasuda Bank which dominated the Yasuda zaibatsu before WW II. However, with its heavy



Mitsubishi Bank's headquarters is located in "Mitsubishi Village" in the Marunouchi area by Tokyo Station.

concentration in the financial sector and having few manufacturers within the group, the Yasuda zaibatsu was closer in nature to the Dai-Ichi Kangin and Sanwa groups.)

Immediately following the war, the zaibatsu were dismantled by the occupying forces. Since then, however, ex-zaibatsu member companies have gradually strengthened their ties through mutual shareholding and other measures. The latter three, the Fuyo, Dai-Ichi Kangin and Sanwa groups were organized in a way that the core bank emulated ex-zaibatsu groups by incorporating its client manufacturers. However, as this connection is relatively weak, the Mitsui, Mitsubishi and Sumitomo groups are still the most representative of a typical horizontal keiretsu.

These groups each consist of more than 20 companies including banks, manufacturers, insurance and general trading companies. All members are leading, major Japanese corporations, although, of course, many other leading companies do not belong to such groups. These member companies are integrated through mutual share-

holding, the transfer of executives, financing from the group's financial organizations and reciprocal trading of goods and services. Also, each group has a top management association called the President Society. Usually the membership of a company in the group is recognized by the fact that its president is a member of this society.

Mutual shareholding is not a phenomenon particular to keiretsu. It is a fairly common practice in Japan for a company to have some of its own shares held by business partners as stable shareholders (about 70% of total outstanding shares in Japan are held by corporations). What is unique about keiretsu shareholding is that when company A, B, C and D belong to the same keiretsu, company A holds shares in company B, C and D, while company B holds shares in company A, C and D, and so on. Thus, although each company's share in a member company is insignificant, representing only around 1%, combined shares of all keiretsu members—more than 20 companies—account for more than 20% of the total outstanding shares.

This pattern of mutual shareholding was shaped by historical and institutional conditions. When the zaibatsu groups were dismantled after WW II, shares held by the core companies were offered to the public. Ex-zaibatsu companies were then met with buyouts. The Anti-Monopoly Law, which was introduced concurrently with the dismantling of the zaibatsu, prohibits holding companies, and the Japanese commercial code does not allow companies to buy back their own shares, so countermeasures against buyout bids were limited. Under such circumstances companies started to maneuver to have their trading partners hold some of their own shares on a semi-permanent basis (stable shareholders) to prevent buyouts. For ex-zaibatsu affiliates, it naturally turned out that other ex-members became mutual long-term shareholders.

This process has been accelerated through subsequent developments, like stock recessions and capital deregulations, to establish the current mutual shareholding pattern. It is common in

any country for managers to try to take measures against takeover bids; in the U.S., countermeasures are provided in the corporate code and state laws, while in Germany banks play the dominant role in stable shareholding. (Japan's Anti-Monopoly Law sets upper limits in bank shareholding.) In Japan, this is conducted by creating stable shareholders, and in the case of ex-zaibatsu affiliates, by mutual shareholding with other ex-members. It should be noted here that because of Japan's lifetime employment system, both the employer and employees are adverse to takeovers. It seems arguable, however, as to whether the creation of stable shareholders has led to a higher degree of competitiveness between Japanese companies by releasing managers from takeover threats and allowing commitment to capital spending and research and development on a long-term basis, or instead, has resulted in loose management as managers became insulated from the capital market rules.

Transferring executives is not very common. Regarding its relations with banks, the biggest financier is generally called the main-bank and is believed to have significant influence on management of the company. However, companies gradually became less dependent on bank loans after the 1980s, and also it is not clear how much ability banks have to monitor the management of, and if necessary give advice to, their clients. In any case, the relationship between the keiretsu bank and its clients can be seen as similar to that general relationship between banks and corporations in Japan.

Goods and services trade within a keiretsu would seem to be the most interesting aspect from the perspective of trade friction, yet the actual trading volume with other keiretsu members accounts for only about 10% of the total sales and purchases of a keiretsu company. Purchases of machinery and equipment, which play a vital role in production activities, naturally take into effect price, quality, and delivery time of the product. Whether the parts are produced by a keiretsu member or not is not the main concern. In the case of certain

products like insurance, however, where detailed government regulations have standardized the quality of products to such an extent that there is little difference between the companies which sell the product, keiretsu companies tend to favor other members. Thus, although marginal, group membership could have a certain effect on trading decisions.

The second group, vertical keiretsu, refers to the relationship between a big assembler and its parts and materials suppliers of small and medium size (some have grown very large), mainly in assembly manufacture such as electrical machinery and the auto industry. Japanese auto assemblers produce only vital parts, purchasing most component parts from outside suppliers, as opposed to highly vertically integrated U.S. assemblers, which tend to manufacture most of their parts in-house. This approach to production in Japan started, for the most part, only during the Second World War. The prewar in-house production ratio of Japanese auto assemblers was considerably high. Similarly, U.S. makers had a period when they relied heavily on outside suppliers. In this sense, it is wrong to seek reasons for the development of this kind of production system in Japan's cultural background.

The development of the current heavy outsourcing production system in Japan is due to several factors. Facing rapid postwar growth demands, makers whose managerial resources were limited concentrated their resources on the assembly process and for parts production resorted to numerous small-sized machine makers which had been operating since the prewar period. Also, major corporations have tended to limit the number of employees because of the lifetime employment system and the considerably higher wages paid by larger companies. Finally, government control over industry during the wartime mobilization already had led to the integration of big manufacturers and their parts makers.

As outsource dependency increases and assemblers started outsourcing, not only general parts like screws and nails but also very specific parts, they found

their own performance had become significantly affected by their suppliers' production costs, parts capacity and delivery time. So the assemblers, who have more capital and technology, started to offer these assets to certain part

suppliers to ensure the cost, capacity and delivery time of their parts. In so doing, a long, sustained relationship has developed between certain assemblers and certain suppliers. This is the nature of what is called vertical keiretsu, and can be regarded as an alternative form to the vertically integrated in-house production system which includes the whole process from the raw materials to the finished product. However, even though sustained, this relationship is not permanently fixed and when a new model is introduced new suppliers may be chosen. Also many large suppliers trade with more than two manufacturers.

Distribution keiretsu, the third type, refers to the integration of a manufacturer and its distributors in the industries producing automobiles, consumer electronics, food, drugs and cosmetics. In this case, the retailer sells a certain maker's products exclusively or predominantly, and in return the maker protects the retailer by assigning a territory, gives rebates and in some cases fixes prices (although this is, in the main, illegal with few exceptions). Under distribution keiretsu, intra-brand competition is largely curbed. This is nothing but vertical restraints in economic and antitrust law terms. This system is

still widely intact in Japan because of high land prices and strict legal controls (such as the Large-scale Retail Store Law), which have served to block large-scale store expansions, thereby preserving traditional distribution systems of many small retailers and wholesalers. In addition, enforcement of the Anti-Monopoly Law by the Fair Trade Commission (FTC) has been lax. However, in certain fields such as food, drugs, cosmetics and consumer electronics, the power of distribution keiretsu has begun to decline due to the emergence of discount shops and the FTC's stricter position against manufacturer's retail price control.

Which system is the most beneficial?

In the actual market economy, each company does not behave automatically, responding to prices as in an economics textbook. Actual market economics are shaped by the historical and social influences of each society. South Korea's *cheobol* and European corporate groups are examples of that. Also, according to Harvard historian Alfred Chandler, large U.S. firms with multi-divisions operating in many industries are representative of the U.S.-style corporate group. Japan's keiretsu can be understood within this general context.

Now, let's return to the question of whether keiretsu promotes efficiency through close cooperation and alignment among companies, or prevents new entries through rigid segregation. Given that keiretsu can refer to the aforementioned various forms of corporate integration, it is clearly impossible to give a general answer. It would be necessary to make an objective judgment on a case-by-case basis. The important point here is, of course, to include the view of whether the system of institutional arrangements called keiretsu is beneficial to the consumer, rather than evaluate it simply in terms of producer efficiency.

Goto Akira is a professor at the Department of Economics, Hitotsubashi University.



The Dai-ichi Kangyo Bank was born from a merger in 1971 with Japan's oldest bank, the Dai-ichi Bank. The Dai-ichi Kangyo group consists of 47 members, with capital of ¥2.4 billion and a turnover of ¥65.7 billion. In terms of numbers, it is the biggest group.



While Mitsui reigned as the largest zaibatsu before the war, the main bank was relatively weak. Today's Sakura Bank has its origins in the Mitsui Bank and Taiyo-Kobe Bank merger.