

# Reforming Japanese Capitalism

By Iwao Nakatani

Japan has been phenomenally successful with its postwar economic system (which I shall call Japanese capitalism). Yet at the same time, Japan has also been subject to criticism from foreign observers and competitors charging that its closed *keiretsu* system, opaque market mechanisms, long working hours, pile-on investment practices and other practices are somehow "unfair."

Is it possible for Japan to respond to this international criticism while still preserving the best of the Japanese system?

## The secret of Japan's economic success

Sophisticated networking is at the very heart of Japan's economic success. There is a heavy emphasis on sustained, long-term relationships in Japan—as seen in the giant corporations' relations with their subcontractors providing parts and assemblies in the manufacturing sector, and in the cross-shareholding and main-bank relationships in the financial sector—and it is this system of close networking among companies that underlies Japan's competitive edge in industries such as automobiles, electronics, semiconductors and machine tools.

At the other end of the spectrum is the heavy emphasis the American system places on markets. While American businesspeople have recently begun to acknowledge the importance of long-term corporate relationships, it is still safe on the whole to characterize the Japanese system as network-oriented and the American system as market-oriented.

In almost all cases, Japanese-style business dealings are long-term relationships between people who know each other. In contrast, most market-centered business dealings are transactions between anonymous ciphers on the open market. What, you may ask, are the differences between Japanese-style personalized relationships and market-based impersonal relationships?



The 1992 Japan-U.S. Business Conference, held over two days in Tokyo in mid-July, called for among others a new vision in market access between the two countries.

Studying the impact of information on economics, scholars have recently found that there is less of an "information gap" and a better "balance of information" in long-term personal business relationships. In any business relationship, there is a natural "information gap" between seller and buyer about the product in question. To take a very everyday example, the automobile dealer typically knows more about the car he is trying to sell than the walk-in customer does. If this is viewed as a one-time relationship, it is easy for the seller to exploit this superior information base and to make the sale on very advantageous terms. Indeed, this is the stereotype of the used car dealer.

But when the relationship is ongoing, the seller has to wonder if such behavior will not amount to cutting his own throat, in that taking undue advantage of a customer will result in a loss of customer trust and hence a loss of business. Want-

ing the repeat business, the dealer is less likely to knowingly sell you a lemon. As a result, long-term business relationships tend to mitigate the buyer's information disadvantage.

This is also true in the financial sector. Since main banks have a wealth of information on their close customers, they do not need to run the same detailed credit checks on the company's performance or investment strategy as they would do for a new client. This means that the screening costs less, is quicker, and risks less. There is much less of an information gap between the buyer (the bank) and the seller (the company that wants the loan), and financial transactions are more efficient as a result.

In addition to this close networking among companies, there are also close relations between government and industry, and it is well known that the government is also a crucial part of Japan's network-based economic system.

Photo: Kyodo News Service



## The system's shortcomings

Japan's network-based capitalism has proved to be more efficient than America's market-based system in a number of crucial ways, and this efficiency is thought to have been important in enhancing Japanese companies' international competitiveness. Just because it works in and for one country, however, is no reason to assume that Japanese capitalism is a universally effective model.

Any model that presumes to be a universal role model must serve to improve the popular welfare worldwide. But there is no assurance that living standards would go up worldwide if the whole world took to Japanese-style inter-corporate networking and cross-shareholding. While Japanese capitalism has a proven capacity to alleviate some of the inefficiencies of the American market-based system, the global implications are still unclear. It is thus worth looking at the five main criticisms leveled against the Japanese system.

### 1. Exclusionary nature

Japan's network-based corporate system is undeniably more inaccessible and exclusionary than the American market-based system. By way of illustration, foreign firms account for only 1% of total sales in Japan but have at least several percent of the American market. Further substantiating this is the very low rate of direct foreign investment in Japan, which indicates the difficulty foreign firms have in becoming part of the Japanese corporate network.

One solution would be to open Japan's corporate networks to foreign concerns—for Japanese corporations to take the initiative in internationalizing their networks. A company's expanding its network system (either by expanding the present networks or by setting up additional networks) to include members of other networks and foreign companies that are not now in any Japanese network would also do much to make its network system more dynamic. Western auto parts manufacturers, for example, should be invited to establish long-term relationships with Toyota or Nissan.

It should be made very clear from the outset, however, that these network relationships are not limited to the buying and selling of finished products, but encompass the full spectrum of close cooperation from product design through sales and service. Foreign firms wanting to enter into network arrangements with Japanese firms need to be prepared for this full-partnership relationship of long-term, shared interests. Simply clamoring for Japan to buy more American products, as some U.S. government officials have done, is not the answer.

Likewise, the Japanese government should devise incentives to encourage the participation of foreign firms, from the design stage on. Japanese firms may find it more expensive in the short term to team up with foreign firms in this way, but such partnerships are vital to demonstrating the universality of Japan's corporate networking system over the long term.

Remembering that the real purpose of networking is to facilitate encounters with different ways of thinking and to stimulate innovative approaches, Japanese companies should cooperate unstintingly with such network globalization.

### 2. Compulsory aspects

The almost-dictatorial power that parent companies have over their subcontractor subsidiaries is the second feature making many people wonder whether Japan's networking system can have global appeal.

The just-in-time system developed by Toyota, for example, has been characterized as turning subcontractors and suppliers into high-precision automatons. When the supplier is not up to par technically, the parent company sends its own experts to the supplier to provide rigorous technical training and management until the company is up to speed and the parts meet specifications. While the supplier does win a long-term business relationship, it sacrifices some of its own autonomy in the bargain.

The *keiretsu* groupings and other close business ties have been shown to be extremely efficient and have contributed to creating Japan's dynamic economic system. But taken to extremes, they run the

risk of collusion and coercion. Unless *keiretsu* partnerships can be shown to be networks voluntarily entered into by equal partners, it is unlikely that they will be perceived as having a universal rationality.

### 3. Low profit orientation

The third problematical element of Japanese capitalism is that Japan's biggest and best companies have unusually low profit margins. This trend was highlighted in the ranking in the July 13, 1992 edition of *Business Week* of the top 1,000 global companies. Japanese firms accounted for 245 of the top 1,000 firms ranked by market capitalization. But their return on equity averaged only 7.3%, or slightly more than half the global composite of 14.3% and far below Britain's 17.7%, America's 16.7%, France's 12.9% and Germany's 12.8%.

The reasons why Japanese companies lean to high volume and low margins in this way are too complex to go into here. Suffice it to say that the structure of the capital markets as epitomized by cross-shareholding and the main-bank system are factors. Cross-shareholding, for example, inhibits net suppliers of capital from speaking out, with the result that investors cannot demand a high rate of return on the company's new investment. In other words, the low cost of capital in Japan makes it possible for companies to operate with lower rates of return. Compounding this situation, the company's main bank is more interested in seeing a company expand its turnover than it is in getting a high rate of return, and this has exacerbated the competition for market share and ever-bigger numbers with low margins.

Yet Japanese companies are being urged to correct this large-turnover, small-margin mentality in the face of mounting Western resentment over Japanese firms' low rates of return on investment and aggressive investment tactics. Aggressive investment and disdain for short-term yield may have been acceptable when Japan was not a significant world presence, but Japan now accounts for well over 10% of world GDP and Japanese companies dominate a number of important industries.





Photo: Mainichi Shimbun

District Court Public Prosecutors in Osaka confiscate materials from Itoman Corp., symbolizing a spate of business scandals which have rocked Japan in recent years.

Western shareholders demand consistently high yields, and this makes it very difficult for Western companies to compete against Japanese firms where the shareholders are content with lower yields. This is the main reason that Japanese business is seen as adversarial, and it will be impossible to dispel foreign fears and distrust so long as Japanese firms take advantage of their low cost of capital and other special features of Japanese capital markets to engage in cutthroat competition for market share.

#### 4. No corporate monitoring

While Japan's network-based system works efficiently for participating companies, it works against the interests of non-participants by making it easy for a select few to monopolize information and by encouraging mutual backscratching and collusion. Such abuses are behind the host of business scandals that have rocked Japan over the past few years.

The basic problem is that society does not have any means of checking that business agreements among just a few companies are not at the expense of the greater social good. Osaka-based Itoman

Corp., for example, managed to use dummy subsidiaries to funnel covert funds to organized crime figures for many years. This went undetected by the company's auditors, the board of directors, the shareholders and the firm's main bank for years.

Companies—especially publicly traded companies—have a major impact on society, and it is imperative that there be some sort of mechanism whereby society can make sure that they are aboveboard.

Prevented by corporate cross-shareholding and the ritualistic manner in which annual meetings are conducted from exercising their rights, Japanese shareholders do not have this power. Nor do the labor unions, having forsaken their mandate to protect the workers' interests and to fight against grueling working hours and having been co-opted into spineless cooperation with management.

And nor do the auditors, as an auditing system intended to ensure that firms do not criminally manipulate their accounting is now little more than a rubber stamp. Tigers on form, Japanese auditors are pussycats in substance. It would be

wrong to blame the Itoman auditors for their failure to uncover the vast amount of skullduggery on the Itoman books over the years. This was not their fault so much as it was an inevitable result of the fact that big companies carry tremendous clout in Japan.

If we want to keep things like this from happening again and again, it is essential that Japan strengthen its mechanisms for corporate monitoring, and create some kind of countervailing power able to balance the big companies. More outside directors, legal provisions to protect shareholders' rights, fuller disclosure, stipulating explicit responsibilities for directors and auditors, giving the Fair Trade Commission teeth, and revitalizing the labor movement are all urgently needed.

There is no way that Japan can regain the world's trust or that Japan's efficient network capitalism can be accepted as a universal model, unless Japan can create the mechanisms needed to enable society to constantly monitor companies to see that they do not abuse the information monopolies and mutual backscratching inherent in this network capitalism.

#### 5. Lack of evenhanded transparency

Japanese network capitalism operates more by tacit agreement than by clear and explicit rules. As a result, it often happens that there are no clear legal structures saying what is and is not permissible and what penalties await anyone who transgresses the rules. Instead, Japan operates by "administrative guidance"—famous for its opacity and seen as the major culprit in a system that discriminates against outsiders.

More and more people are coming to view administrative guidance's opaque rules as symbolic of the just-among-us nature of Japanese society and a fundamental source of foreign distrust of Japan. Administrative guidance has to be replaced with a system of clear and explicit rules if Japan is ever to be accepted as a fair player in the global market. ■

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