24-03-2020

Powerhouses

Keiretsus in Japan

Comparative Political Economy

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Number of characters: 22,745

Number of physical pages excl. bibliography and front page: 10

Referencing system: APA (6th edition)

Introduction

The enigmatic business conglomerates in Japan – in Japanese known as *Keiretsu* - are historically known to be the great catalyst for the growth in the Japanese economy. Evolving out of the ashes of the Japanese homeland under Allied military supervision, these conglomerates rebuilt the economy and became the sine qua non in the Japanese economy up until 1990. This is the year the Japanese asset-bubble burst, and a series of market liberalizations were legislated by the government. But what happened to the Keiretsus? And has there been a revival of them since the "Lost Decade"? This paper's research question will be: *How has the role of the Keiretsu been between 1945-1990, 1990-2010 and 2010 till now?* In analysing this diachronically, this paper will be using the Varieties of Capitalism (VoC) to analyse this research question and show how Japan has had its business structured. Later on, this paper will discuss further methods that could have been applied in analysing this research question, and whether or not Japan is actually an ideal type of this variety. In the conclusion, it will be shown that the Keiretsu system is very active in Japan, but in a greatly altered form.

Operationalization of theory

VoC

In order to begin the analysis of the Keiretsu, a definition and operationalization of the theoretical groundwork must be established. VoC, developed by Hall and Soskice (2001), is a firmly centred theory, which focuses on developed nations and which type of capitalism Japan are utilizing. There are two types of capitalism, according to Hall and Soskice: Liberal Market Economies (LME) and Coordinated Market Economies (CME). Both of them are ideal types so that countries employing them are striving to become either-or. In an LME, competitive markets are dominant, and market relationship is set at arms-length. They adjust prices based on supply and demand from the market, in strong accordance with neoclassical economics. In a CME, it is more non-market relationships that are important, as these entail "more extensive relational or incomplete contracting, networking monitoring based on the exchange of private information inside networks and more reliance on collaborative as opposed to competitive" (Hall & Soskice, 2001, p. 8). Here, it is not as much supply and demand that determine production, but more strategic coordination between firms.

Hall and Soskice (2001) divide these relational aspects of the countries' “firm structure” into 5: 1. Corporate governance: how to secure funding 2. Industrial relations: How to keep wages low and productivity high. 3. Vocational training and education: How to secure a suitably skilled workforce 4. Employees: How to keep employees from “sabotaging” the firm 5. Inter-firm relations: How to compete/collaborate with other firms.

This paper will focus only on 3 of these aspects: inter-firm relations, corporate governance and vocational training, given the significance of these to the Keiretsu.

Furthermore, these two types of capitalism have their own set of institutional complementarities. In a CME, for example, this could be that the low level of stock capitalization results in a higher degree of employment protection, and vice versa for LMEs' (Hall & Soskice, 2001). Thus, LMEs' tend to rely more on market coordination, while CMEs rely more on non-market coordination in the industrial sphere. This type of coordination then has spill-over effects in other areas, like the above-mentioned relation aspects; for instance, the vocational training is specialised in CME. It is more general in LME, due to lower level of employer protection. This shows how complimentary the different institutions are, based on their culture and historical context, and the stronger the complementarities are, the better the economic performance will be (Hall & Soskice, 2001). This will be shown very clearly with the Japanese situation, given its history and culture.

Japan 1865-1990

The Japanese economy was opened for trade, after having been highly esoteric. After the Act of Seclusion in 1639 (Toby, 1977), Japan completely shut off any and all outside interaction. When it came to business, profits were looked down upon, given that the economic relations were given by the adherence to *bushido,* which is a set of codes that had incorporated Confucian ideas. (Grabowicki, 2006) These ideas reinforced the concepts of a harmonious society, and many of the merchants operating in Japan were former samurais, who honoured those ideas. These samurais gave rise to great merchant families, that would dominate the Japanese economy, such as the Mitsui (Grabowicki, 2006). However, the economy was still strictly under the command of the Shogun (Baron) or some of the Daymu (feudal lords). This changed with the Meji restoration in 1868, where the emperor consolidated power and went through massive reforms, economic opening and a hyper modernization, but mainly in material and not in spirit. So, while market reforms, stock market opening, and great banks had risen, there was still social feudalism (Grabowicki, 2006). They also initiated large scale privatization of formerly state-owned industries and gave rise to the predecessor of the Keiretsu group, namely the Zaibatsu groups. These were the previously mentioned samurai merchant families, who gained all the firms. The reason was that these families had so much knowledge of running these enterprises, not possible to achieve in middle class Japan, simply because Japan did not have a middle class. So, these families were the only ones who could run them. These family-run ventures were constructed, such that the family had complete control of the entire business network, like a pyramid structure. A holding company (*Honsha)* was situated at the top and had control of suppliers and subsidiaries through majority shareholding (Grabowicki, 2006). The Mitsui family, for an example, had a pyramid structure. In 1876, the Mitsui family funded a bank, that would work as the holding company overseeing and controlling the pyramid scheme. To conclude, Zaibatsus came to completely dominate the Japanese economy in the Meji Restoration up-until WWII where they were state controlled, for wartime economy.

The Zaibatsus broke down after WWII. The breakdown happened due to the defeat of the Japanese Empire during WWII, and the subsequent occupation by the Allied forces, in particular the US. The US broke up the massive monopolies and privatized them yet again, but this time, there was a middle class, and quickly, new companies rose, such as Sony and Honda (Grabowicki, 2006). New bank lending policies allowed private banks to give credit to firms, if they complied with the conditions of the Ministry of International Trade and Industry (MITI), as the private banks financed themselves through trust funds, which were publicly owned. Thus, there were banks propping up certain companies, who demonstrated a very harmonious relationship between the board of directors and [labour unions, developed under WWII, and they introduced new modern management methods. This synthesis between the Zaibatsu and the West had led to the Keiretsu, which emerged in the 1950s. (Grabowicki, 2006). These were more network structured than pyramid structured. It goes without saying, that this was a very developed CME country.

There were two types of Keiretsu's (Russel, 2018): horizontal and vertical.

The vertical one resembles vertical integration in a modern sense where, for example, a car company has great relationships with a rubber company along with glass and steel companies. These supplier companies know exactly what type of tire that the other one wants, through educational vocational training. The steel company knows what type of chassis that it should produce, and the glass company knows the windshield. They did personnel transfers, which is in accordance with Hall and Soskice (2001), and their vocational training. In a CME, specialized skills are more required than broad skills, given the cooperation of companies in order to produce the best results. To mitigate the risks, they also did cross-shareholding in the vertical Keiretzu (Grabowicki, 2006), to keep them afloat financially. This also indicates a CME, as they collaborate more than compete, in this market.

The horizontal Keiretsus are slightly different, as they operate across sectors. Several times, the horizontal Keiretsus were anchored by a bank in the middle, that secured finance and loans for the companies (Grabowicki, 2006), which is in accordance with the corporate governance sphere of a CME (Hall & Soskice, 2001). Referering back to the Zaibatsus, there is also cross company shareholding, and the main coordination mechanism is a meeting of the CEO's club, called a shacho-kai (Russel, 2018). A combination of the vertical and the horizontal shows how influential they were, as massive parts of the economy belonged to a Keiretsu network. David Russel (2018) describes them as "solar systems." Grabowicki also states, that "the size of this network creates the overall impression, that 'the whole of Japan is one big keiretsu'." (2006, p. 30).

These companies dominated the Japanese economy. From their inception in the 1950s up until the 1970s, the economy of Japan's growth rate exceeded multiple times 10%, and from 1970 until 1990, it was at 5%, both on a real GDP basis. (Yoshioka & Kawasaki, 2016). During this period, it was also the MITI, that cooperated with and sponsored Japanese industries with high potential through capital flows, mentioned above in regard to the banking practices (Tsutsui & Mazzotta, 2015) (Yoshioka & Kawasaki, 2016). This indicates institutional complementariness on the CME basis, where the private and financial sector worked quite well together – with a great oversight from the government - and spurred growth. Much of this growth was also a result of the "aggressive exports" and "closed market" (Tsutsui & Mazzotta, 2015, p. 60) made available by the Keiretsu model of risk minimization (Grabowicki, 2006), so foreign firms had trouble competing. Furthermore, they also spurred domestic supply and demand (Grabowicki, 2006), which made the Japanese high consuming citizens (Tsutsui & Mazzotta, 2015). This paper shall return to this point later. In the 1980s, Japan almost caught up to the US, in terms of per capita national income (Takashima, 2007). However, this growth did not last.

Japan 1990 -2000 – The Lost Decade.

Events surreptitiously took a turn for the worse in the late 80s, when it otherwise seemed to be going really well for the Japanese economy. Corporations and financial titans started a buying spree (Tsutsui & Mazzotta, 2015). In 1985, the Plaza Accords were negotiated, with the aim of weakening the dollar against the yen, in order to bring down the enormous trade surplus that Japan had gathered on its current account (Tsutsui & Mazzotta, 2015). At the same time, the Structural Impediments Initiative was being planned in 1990, that demanded the Keiretsus to be "cracked open," as they were oligopolistic in nature and excluded foreign companies and FDI (Matsushita, 1990). However, at that point, Keiretsus had begun spending a lot of money, and the banks could not keep up with the loans (Tsutsui & Mazzotta, 2015). This was due to the government having taken some of the trade surplus savings and had started to promote private investment by lowering interest rate (Fukako, 2010). The lowering of interest rates was also to counter the effect of the appreciation of the yen. So, being unable to obtain bank credit, Keiretsus like Toyota issued bonds instead (Tsutsui & Mazzotta, 2015) and banks speculated in real estate, that grew into an enormous bubble. But in the SII, there was also was a call to implement laws to lower the price on land as consumers in Japan could not keep up spending with the rising house prices (Matsushita, 1990). Thus, in the first 30 months of the 1990s, 2.5 trillion dollars of wealth went up in thin air (Tsutsui & Mazzotta, 2015). The sword of Damocles had finally dropped. Real unemployment rate rose to 9% in 2003, as the optimistic investments in – among other things – the manufacturing industries, had provided a production glut. So, the companies had to lay off workers, cut production costs etc. to keep afloat. (Tsutsui & Mazzotta, 2015) Given the Keiretsu structure, the banks continued providing credits to companies that were highly insolvent and could not pay back, called "zombie companies". This inflexibility of the Keiretsu system was a considerable component of the crisis.

However, the Japanese policymakers introduced some new extensive changes to the economy in 1996. It was time for deregulation, such that other companies could enter the economic scene (Lincoln & Litan, 1998). These measures sought to spur competition from the outside, and they, thus, pricked a hole in the insulated Japanese economy. The deregulation was called “The Big Bang”, and was meant to transform the Japanese economic system from “a highly-oriented bank oriented financial system to a more market-based financial system” (Aaronson, 2011). This loosening up of the bank sector would also spur credit funding to SME’s by the banks, in a way that they had been reluctant to do before (Yoshino & Taghhizadeh-Hesary, 2015). But even with these newly minted regulations, growth was still sluggish. (Aaronson, 2011). However, this is a clear notion, that the institutional complementarities were diminishing, and that Japan was moving away from the ideal type CME and adopted practices that were more akin to the LME, making it more difficult to have close relations between firms. Among the other practices changed were the following (Yoshino & Taghhizadeh-Hesary, 2015):

1. Less labour protection, given the high aging population and wages were based on seniority and not productivity.

2. Switching to a US 401k-style from a Pay-as-you-go system. In the old system, the Japanese client did not have any control over their savings, and let the government decide on how to allocate their funds to different financial products.

3. Switching from collateral principle (how much collateral a company could come up with) when it came to invest, to actually assessing how viable the project. The “viability way” had been a classic Anglo-American way of doing it.

This altering of the Japanese institutional structure helped moulding Japan into a more LME focussed country had huge consequences for the Keiretsus. The banks who had been the anchor of the major horizontal Keiretsus were suddenly not so eager to lend to them anymore. This also resulted in a diminishing of cross shareholding between companies, anchored to the banks, as the banks needed to sell shares to remain solvent. (Russel, 2018). So, the previous very strong coordination within the Keiretsus was beginning to crumble as a result of the 1992 asset-bubble being priced, and given that the coordination between companies being the most important aspect of the Keiretsu according to Grabowicki (2006), a major column in the relations had been torn down. And the CME model went right with it, given the new LME rules that emerged from the SII and Japan's own governmental restructuring.

Reinventing the Keiretsu 2000-2019

However, during the last decade it is clear to see that the Keiretsu business model has made a comeback, although in a more open and different form, according to Katsuki Aoki and Thomas Lenerfors (2013). Aoki and Lennerfors have used Toyota as a case study on how the Keiretsu has evolved since the 1990s, with focus on the vertical Keiretsu. Given that all liquidity had dried up, some of the automakers, including Toyota, went looking for foreign capital and opened up for FDI. Thus, diverting from the classic corporate governance model of the Keiretsu, and being more competitive-market oriented, when it comes to financing and cooperate governance. (Aoki & Lennerfors, 2013)

Toyota has adopted the strategy, that instead of only buying parts from very close supplier relationships, in which they also owe a part, they have also started to buy from global mega suppliers, which lowers costs and keeps Toyota competitive (Aoki & Lennerfors, 2013). So, Toyota have adopted the arms-length relationships found in LMEs while still retaining CME type close-coordination (Hall & Soskice, 2001). And instead of only buying parts - as was the norm from the hey-day of the Keiretsu - they are buying entire systems to save costs and time. Toyota initiated the strategy in 2000, called the "Construction of Cost Competitiveness for the 21st Century" (CCC21). This also indicates a radical change in the inter-firm relations (Hall & Soskice, 2001), as Toyota have gone away from exclusively having suppliers based on non-market relationships and also adopted market-based relationships. (Aoki & Lennerfors, 2013) But it still maintains good relationships, given that when their suppliers are being price-pressured through from the outside by other firms, Toyota – instead of abandoning them – sends out "study groups" that will help to reduce costs, optimize the process and improve the quality. This of course also implies, that Toyota uses a lot of vocational training, both within the firm, but also cross-firm, in order to secure overall quality.

Toyota also focusses on “goodwill and trust” (Aoki & Lennerfors, 2013), when it comes to their supplier deals, especially when it comes to innovation. Because of this, Toyota requires its suppliers to have a deep understanding of the processes and manufacturing goals of Toyota. The understanding is conveyed through Toyota’s educational program. Toyota want to store up “tacit knowledge” through trial-and-error problem solving, sharing of work experiences etc. with their supplier, to optimize production. Toyota being there physically builds up trust and goodwill with its suppliers and manufacturers – a vital success criterion in long-term relations. Furthermore, Toyota holds “Obeya’s,” which are great meetings in which several people in the vertical Keiretsu attend. Here they discuss future products and the feasibility of those products. This is a classic CME trait of strategic cooperation among firms, instead of hardcore competition. (Hall & Soskice, 2001)

So, the vertical Keiretsu has changed a lot, but is still intact. Nissan and Honda are adopting the same strategy as Toytoa, has adopted that strategy of both doing mega suppliers at arms-length alongside close relationships (Aoki & Lennerfors, 2013). With the horizontal Keiretsu, however, the situation has changed a lot, given the prevalence of FDI, where, for example, Mitsubishi (one of the original Zaibatsus) has a foreign shareholding of 32% in its trading house (Masaharu, et al., 2017). Foreign investors see the old corporate finance structure of cross-shareholding as ineffective, as they keep companies alive that should not be (Tsutsui & Mazzotta, 2015) and one does not ignore a third of one’s shareholders. The old shacho-kais have also evolved in the case of Mitsubishi, and it now more about philanthropy than inter-firm relations and corporate finance governance. (Masaharu, et al., 2017).

Thus, the Keiretsu system is still intact, but it has changed a lot and is a lot more focused on effectiveness and competitiveness than long term stability. The Keiretsus have undergone a contingent development, where they are now more in tune with the outside world. This had made them into a hybrid between LME and CME.

Discussion

Continuing from the end of part 3, this hybrid is according to Hall and Soskice not possible (2001). As stated in the theoretical section, a nation has to aspire to one of these ideal types, but not a hybrid, as that would not work. As it turns out, even though Hall and Soskice have used Japan as a prime example of CME, it is not aspiring to it. Grabowicki observes, for example, that labour bargaining is actually more company based rather than based on strong unions (2006). This practice is more akin to an LME-system, rather than a CME-system, and yet Japan had that, even before the asset-bubble burst in 1992 (Grabowicki, 2006). Furthermore, Japan is known for making radical innovation (Carter, 2019), which again is more akin to an LME, whereas CMEs' are known for incremental innovation. This does not suit the VoC approach. In practice, countries can indeed function as a hybrid between those two paradigms.

Other methods of analysis that could have been used in this paper is constructivism. The three orders of change (Hall, 1993) could have been used to analyse the paradigm shift and social learning when it comes to the Keiretsu, who's change emerged due to the asset bubble crash in 1992. Bricolage or translation could also have worked well in order to highlight the shift of institutional instruments and thinking during the periods of analysis (Clift, 2012).

Esping-Andersen's three welfare regimes (Emmenegger, et al., 2015) would have been difficult to apply, as Keiretsus are businesses. It could have been apt to look at how Keiretsu influences welfare in the country, but not in analysing the business aspects. Furthermore, it would have been difficult to analyse the Keiretsu utilizing Hemerijck's (Hemrijck, 2012) transformation scheme, due to the same reasons.

The SSA approach (McDonough, 2015) could have been used, as Keiretsu did face a crisis in the 1990's and one could identify the institutional fix, that was given to them from the governmental institutions, to keep the growth up. Also, analysing the hegemonic idea of the Keiretsu as an accumulation scheme, would have been valuable.

Conclusion

This paper has shown that the Keiretsu system is very old and has deep roots in Japanese culture and history and is hugely affecting the economy today. The Keiretsu system was the source of growth in the middle of the 20'th century. But given the SII and Plaza Accords, the system could not withhold itself, and it became unsustainable. The SII and Plaza Accords had a significant role in the bursting of the asset-bubble in 1992 and initiating the Lost Decade. It has then been shown, that from a few adaptions and twists, the Keiretsu system survived the bubble-bursting, but opened up to FDI – negating the horizontal Keiretsu – and forcing the vertical Keiretsu into adopting LME- type relations, thus turning the Keiretsu system into a hybrid. However, the gist of the Keiretsu is still there: there are still deep supplier-manufacturer relations in the vertical ones, and the horizontal ones still meet up and retain good relations with one another. Thus, the Keiretsu is still a force to be reckoned with in modern day Japan.

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