RE-EVALUATING THE JAPANESE CORPORATE SYSTEM

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Re-evaluating the Japanese Corporate System

Many surprising events have struck Japan since the beginning of 1995. First, the earthquake, second the sarin attack by the Aum Shinrikyo religious sect, and third, political turmoil in the aftermath of the dissolution of old Liberal Democratic Party. Above all, the effect of the disappearance of the ruling conservative party is indeed significant. There are very clear signals that the Japanese political and economic system of 1955, which supported the high growth of Japan in the early postwar years, has ended once and for all. The people are disenchanted with the old-style party politicking. This is an era of political instability and economic stagnation.

The Japanese economy is said to have hit bottom in October, 1993. Since then, there has been some recovery in manufacturing industries, reflecting strong overseas demand and modest growth of domestic consumption. Plant and equipment investment, which has shown a net decrease for past three years, is expected to show modest growth of 2.9% in 1995. In comparison with the manufacturing sector, recovery in the tertiary sector, such as services and commerce, is lagging behind both in sales and profit.

While the flow of goods and services is slowly recovering, the economy is beset by serious effects of asset deflation. The Nikkei average stock price plunged from 39,000 yen in November 1989 to now hover around the 16,000 yen level. Real estate prices have fallen for four consecutive years, and are still falling. Banks are said to have huge amounts of non-performing assets, many of them collateralized by land which has lost its value.

Despite the optimistic view of the government, forecasting 2.8% growth for 1995, many private economic institutes are expecting a real growth rate of around 1.3% for 1995. One and a half years after the business cycle hit bottom in October 1993, asset deflation has not stopped, and
is slowing the recovery of the economy to a snail's pace.

Considering the fact that the average length of the postwar Japanese business upswing is 26 months, people are now beginning to wonder whether this is a real recovery or something which runs out of steam before anybody feels a real, robust recovery of their business.

Reflecting such gloomy economic realities, the Japanese business community is now in the midst of a painful process of reevaluating the Japanese corporate capitalism and its management system. Having experienced the bursting of the bubble economy, having gotten their fingers burnt by collapse of stock and land prices, and having experienced endless escalation of the yen, the so-called Japanese management system, which supported postwar growth and about which we Japanese became very proud, is now in question. People are asking if this system may have lost its viability under present economic conditions, and is no longer suitable for the future.

This re-evaluation is taking place in roughly four areas. The first one is the employment relationship. It is felt that lifetime employment, the seniority-based promotion system, automatic escalation of salaries, and intracompany unions: these systems can no longer be sustained. In a period of low growth, companies cannot take care of their employees for life, and the system has to be changed to a more fluid, market-based employment relationship. This is the feeling which is prevailing now.

A second area of reevaluation is the fear of the hollowing out of Japanese industry. If yen appreciation continues, automobiles and electronics—the so-called cream of Japanese industry—will have to move overseas in search of cheaper labor. And what's left in Japan will be the tertiary sector of the economy, which suffers from low levels of productivity.
Third is dissatisfaction with the “high cost, high price” structure of the Japanese economy. It is said that the distribution system in Japan is complicated, multilayered, and heavily controlled by government regulation. As a result, even inexpensive imports become expensive by the time they reach the hand of the consumer. Hence Japanese do not enjoy the benefits of strong yen. There is a strong feeling that the Japanese are penalized by the very success achieved through their hard work, and there is an outcry for the massive removal of government regulations, which have tended to preserve all these inefficiencies.

The fourth area is the call for realignment of relationships among companies. As you are aware, Japanese companies are formed into various groups called keiretsu. There are vertical keiretsu and horizontal keiretsu. Horizontal keiretsu are business groupings like Mitsui and Mitsubishi formed around related companies in each of several leading industries--typically, banks, trading companies, manufacturing companies, mining companies, etc.

The vertical keiretsu is something which you see under Toyota. Toyota has a few hundred primary subcontractors, several hundred secondary contractors, and a few thousand tertiary subcontractors. And there is this famous custom of mochiai, which is mutual holding of shares between the companies, and between the companies and banks. Now, there is a strong feeling that such rigid group relationships must be change into more fluid relationships reflecting market conditions. And the mochiai shareholding cannot be sustained unless share prices can be expected to continue to rise. Because after all, at the present depressed price of the Tokyo Stock Exchange, yield on the investment in Tokyo Stock Exchange is about 1% at best. So companies cannot afford to invest in stocks in Japan, unless there is expectation of a continued price rise.

These are four areas where this serious re-evaluation is taking place. Japanese
businessmen and bureaucrats alike have now lost confidence in their established system of Japanese corporate capitalism. This change from excessive self-confidence, which had prevailed in late 1980s, when Japanese were buying Rockefeller Center and many hotels in Waikiki Beach, to the very severe self-criticism, is indeed very dramatic.

Why is such a sudden loss of confidence and change of attitude taking place now? I think there are two underlying factors. One is the realization that the Japanese economy has reached the point of maturity. Up until the 1970s, the Japanese economy used to grow at 10% per annum. In 1980s, it grew at 5% per annum, and in the 1990s, we are struggling to achieve the average growth rate of less than 3%. It is felt that the high growth system must be modified to fit the era of low growth.

Another factor is the realization of globalization of the economic system. It is no longer possible to keep Japanese economy isolated from the rest of the world. It is no longer possible to keep the fence high enough for global movement of goods, money, and people. The Japanese system must be aligned with the worldwide system.

I wish to stop here for a moment to examine the question of what is the central problem in the Japanese economy that given rise to all these re-evaluations and re-examinations. All evidence points to the fact that the Japanese economy suffers from the problem of dual structure. On the one hand, you have the automobile industry, and electronics, Toyota and Sony, which have grown under global competition. They have relentlessly rationalized their factories and improved operations, with the result that they probably enjoy the highest level of productivity in the world. They continue to improve operations under everlasting appreciation of yen. They were very alarmed when yen started to appreciate from 250 yen to the dollar in 1985, and they struggled to
stay competitive by rationalizing and cost-cutting. Today, at 90 yen, or even 86 yen to a dollar, many of them are still competitive. And Japan is still earning 120 billion dollars of trade surplus. And that drives the yen still higher. While I have all the admiration for the rationalization efforts of these industries, from the standpoint of the national economy, this is indeed a vicious circle.

On the other hand, there is a huge economic sector in Japan which, under the government protection, has never been exposed to international competition and has remained at a very low productivity level. A typical example is agriculture. The cost of production of rice in Japan is several times higher than the world market price. There are hundreds of thousands of small companies in manufacturing in non-exporting industries, and in retail, wholesale, and service industries. Since the domestic price level tends to be determined by the productivity of these domestic-oriented business, purchasing power of the yen is not 90 yen to a dollar, as in international markets, but much weaker. Various studies have been made of so-called purchasing power parity (PPP), and it is expected that on a PPP basis, the yen may be 150 yen to a US dollar, or 180 yen, or even 200 yen. By making use of some tables produced by the World Bank and McKinsey, I wish to demonstrate the magnitude of this dual structure problem.

Table I was made by the World Bank, and shows the income comparison in 1993 in US dollars. At the end of 1993, the market rate between the Japanese yen and dollar was 113 yen, and on that basis Japan had the GNP per capita of 31,000 dollars, as against 25,000 dollars for the U.S. But on a purchasing power basis, in the second column, Japan's GNP per capita was 21,000 dollars, meaning that on a PPP basis one dollar was 1.5 times the parity in the exchange market. And it is indeed noteworthy that on this basis Japan's GNP per capita is much lower than it was in the United States, and was at about the same level as Singapore and Hong Kong.
And I go to the Table II. This is a study made by McKinsey, a case study of nine industries in Japan on the basis of employment share and relative productivity level in 1990. The red, horizontal line, is the United States as 100. And this is to try to make comparison of the productivity level of these nine different industries in Japan against the United States counterpart. You notice that the steel industry shown on the extreme left has a very high level of productivity in Japan, 145 against 100 for the US. And automotive parts have a productivity of 124 against 100 for the US, and so on for metalworking, car manufacturing, consumer electronics. And then in computers, Japanese productivity is slightly below that of the United States, with 95, and soap and detergent is 94, and beer is 69. But my point here is that we have huge sectors, like the food industry, which suffer from low level of productivity—about one third that of the United States. An important fact here is that this sector is a very large employer in Japan. Many people work in industries with low productivity, suggesting the magnitude of the dual economic structure problem.

Some weeks ago I was invited to make a presentation on NHK television, and there I spoke about the white collar productivity. It is my belief that the gap between the productivity of blue collar workers in very highly competitive export-oriented industries and white collar workers in offices or service shops is just as great as the productivity gap between export industry and domestic industry. Even the most competitive Japanese companies which achieved the highest level of productivity in the factory floor, are burdened by huge and very unproductive central offices and service organizations.

I talked about the culture shock I experienced when I joined an American company by talking about voice mail and electronic mail. Voice mail is an intracompany telephone system
which enables you to leave a message to anybody in the organization, be it that in New York, London, or Hong Kong. Theoretically, this system enables a first year clerk to leave a message to the president, if he feels that the piece of information he has is useful to the president.

But what would happen in a multilayered, seniority-oriented Japanese organization, if you introduced voice mail? A first year clerk may want to leave a message to the president, but if he is a prudent man he might wonder, what would my subsection chief, the section chief, the assistant manager of the department, and so on, all these intermediate management, think about me if I short circuit them by leaving a message to the president? And for that reason, I don't think voice mail will really work in a Japanese corporation, at least in its present condition and atmosphere. I think the voice mail works only in a very flattened and simplified organization without hierarchy. In that sort of environment, it will help speed communication and therefore speed the decision-making process.

We Japanese are all impressed by the dramatic recovery of great American companies through radical restructuring and re-engineering since 1991. It is my feeling that the net increase of productivity was even greater in offices and white collar jobs than in the factories. Japan has a long way to go in improving white collar productivity. This change will have a profound effect upon the Japanese corporate culture, and more specifically, corporate governance and employment practices.

Let us first consider for a moment corporate governance. Americans have a very clear idea that shareholders are the single most important stakeholders, and, therefore, companies must be managed to realize the greatest value for the shareholders. In Japan, partly because of mutual shareholding, which tends to neutralize powers of the shareholders because this is a kind of "I
own you, you own me" relationship, and partly because of lifetime employment, shareholders have never enjoyed a predominant position in corporate governance. Corporations have tended to be managed by professional managers selected from senior employees in a rather self-perpetuating manner. The question is very often asked in Japan, who is the more important stakeholder, a shareholder who buys today and sells tomorrow, or an employee who dedicates his entire working life to the company? With the continuing stagnation of the Tokyo Stock Market, and growing demand from corporate stockholders, however, Japanese management is now finally coming to a realization that more attention must be given to shareholder rights.

Second, let us consider the employment relationship. Earlier, I indicated to you that lifetime employment and the seniority system are now being re-examined. Japanese employees call their company "uchi," which means "our house" or "our home." Japanese employees traditionally made efforts to make their companies nice places to live. Management cooperated by creating more positions and more layers of management in order to accommodate the need of face saving for older employees. To them, corporations are "Gemeinschaft" rather than "Gesellschaft."

Now, unlike in the high growth era, many Japanese companies are not expanding their workforce and organization. These companies are finding it difficult to keep all employees on the payroll, let alone to find them positions commensurate with their seniority level. Now in Japan we have a newly famous word, "madogiwazoku," or window-side employees, meaning older employees who have no work but are kept on payroll and, therefore, are left with nothing to do but look out the window.

There is a strong feeling that lifetime employment is depriving Japanese companies of their ability to restructure and re-engineer. Take, for instance, the Japanese banking system. You will
all recall that in the 1980s, the American banking system went into difficulty, but banks sold off their bad loans, closed branches, and laid off employees. In a few years, they came back as very healthy organizations. Currently, Japanese banks are plagued by large amounts of bad loans. Just because they are unable to reduce workforce, however, they cannot resort to any surgical operation, but must depend upon internal medicine. Therefore, the recovery of Japanese banks will take a fairly long time.

In my opinion, the present system of lifetime employment will soon be somewhat modified or eroded. Restructuring through workforce reduction is on every CEO's mind in Japan, but nobody wants to be the first one to take a move.

All through the postwar years, we Japanese have been accustomed to compare Japan with the United States. When Japanese spoke about the outside world, we always had the United States in mind. We always tried to decide the position of Japan in its relationship to the United States. More recently, however, it is my strong feeling that, in considering systemic differences in the countries, we should not only compare Japan with the United States, but we should include other areas, particularly Europe.

Consider, for instance, the comparison of capitalistic systems of Japan with other major economies. If you place the American market economy on the extreme right of the spectrum, you will probably agree that the Japanese corporate capitalism is to be placed on the extreme left. Americans have the firm belief that the market is the best provider of efficiency, while the Japanese system is based more on the consensus among management, labor, and the government. On this spectrum, the United Kingdom is probably very close to the United States, on the right-hand side. But where is continental Europe? In France and Italy, you have the mixed
economy, where the government owns and controls large banks and corporations and where the
bureaucrats parachute into chairmanship of all leading companies, although recently with a very
strong thrust for privatization. In Germany, you see large banks own shares in leading companies,
and bankers sit on their Aussichtrat, or supervisory board. Probably you'd want to place
continental European system on the left-hand side of the spectrum, very close to Japan.

In the United States, there is a group called revisionists who maintain that Japan is very
eccentric and very special, and, therefore, must be dealt with in a very specialized way. My point,
however, is that in this worldwide spectrum, including continental Europe, Japan is not that
special, at least not Japan alone. Even more, if you include the system of newly industrializing
economies in Asia, you will probably agree that my argument that Japan is not that special will be
strongly reinforced.

 Broadly speaking, the changes that are taking place in Japan are moves to change the
Japanese economy more to a market-based, or more market-driven economy. In my illustration
of a world spectrum, this means that the Japanese economy moves a step toward the United
States. This will involve more respect for shareholder rights, changing lifetime employment into
a more fluid and purpose-oriented employment relationship, making corporate hierarchies simpler
and flatter. However, my emphasis here is that the effort to change the Japanese system should
not be dominated by single-minded approach to copy the American system, but rather should be
pursued with the well-balanced global perspective including Europe and Asia.

 On the national economic level, this means the removal of governmental regulations and
the creation of a more open and transparent market. Keidanren is making an all-out effort to
remove half of all existing regulations in five years. Deregulation will be a difficult and painful
process of sorting out the intricate vested interests of different ministries, industries and companies. But, for the first time in history, there is a national consensus that deregulation is the No. 1 priority.

I said earlier, Japanese are concerned about the hollowing out of the economy. Manufacturing industries are moving to Southeast Asia and investing more abroad than in Japan. But as a matter of fact, the ratio of manufacturing activities done by Japanese firms abroad is only 6.3% of the total. In the case of the US, it is 30%. In the case of Germany, it is 20%. The difficulty for Japan is not that Japanese companies are moving abroad but rather that foreign companies are not investing in Japan. The ratio of foreign direct investment of Japanese industry to the ratio of foreign industry investing directly in Japan is 15:1. That is to say, if Japanese invest 15 million dollars abroad, foreign companies invest only 1 million in Japan. In the case of the US, this balance is roughly 1:1, and in the case of Germany, the balance is roughly 2.5:1.

To sum up, our problem is that the Japanese market is an extremely difficult market for newcomers to enter, be they Japanese or foreigner. Our task is to make the market more open and more accessible. Having said that, I am not advocating an outright change to an American practice of corporate raids and hire and fire. We still attach great value to the traditional Japanese management style of long-term perspective and stable employment. We believe that only with stable employment were Japanese companies able to accumulate technology and skill and attain the highest level of quality control, thereby achieving their present global positions.

We are now going through an agonizing process of re-evaluation in order to create a new Japanese system, a system which would retain certain important values from our traditional system and still be able to withstand the waves of globalization engulfing Japan.
Table I
Income Comparison 1993 in US$

<table>
<thead>
<tr>
<th>Country</th>
<th>GNP/Cap.</th>
<th>GNP/Cap. PPP*</th>
</tr>
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<tbody>
<tr>
<td>Japan</td>
<td>31,450</td>
<td>21,090</td>
</tr>
<tr>
<td>Singapore</td>
<td>19,310</td>
<td>20,470</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>17,860</td>
<td>21,670</td>
</tr>
<tr>
<td>Taiwan*</td>
<td>11,220</td>
<td>16,500</td>
</tr>
<tr>
<td>South Korea</td>
<td>7,670</td>
<td>9,810</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3,160</td>
<td>8,630</td>
</tr>
<tr>
<td>Thailand</td>
<td>2,040</td>
<td>6,390</td>
</tr>
<tr>
<td>Philippines</td>
<td>830</td>
<td>2,660</td>
</tr>
<tr>
<td>Philippines</td>
<td>2,040</td>
<td>6,390</td>
</tr>
<tr>
<td>Indonesia</td>
<td>830</td>
<td>2,660</td>
</tr>
<tr>
<td>China</td>
<td>490</td>
<td>2,120</td>
</tr>
</tbody>
</table>

In comparison:
| Switzerland  | 36,410   | 23,620        |
| USA          | 24,750   | 24,750        |
| UK           | 17,970   | 17,750        |
| India        | 290      | 1,250         |

PPP* = calculated on a purchasing power parity
*Own estimates
Table II
Employment Share and Relative Productivity Levels in Japan 1990 for Nine Case Studies
Index: U.S. = 100