

An Analytical Guide to Corporate Japan Today

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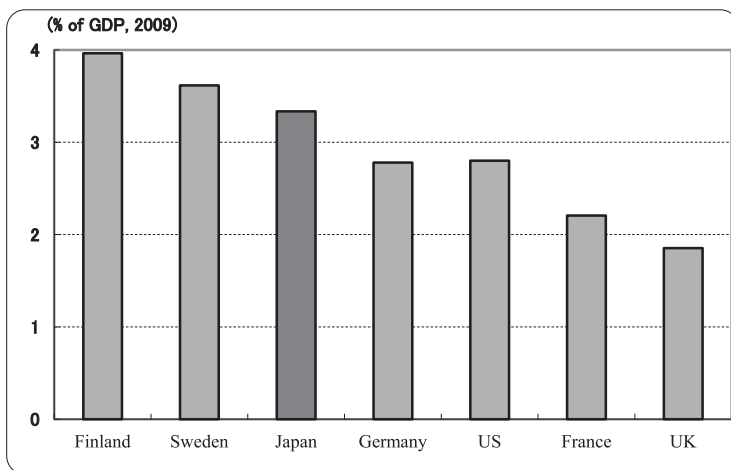
1. Strong and Weak Suits

A good starting point for understanding Japan's corporate sector is to learn its strengths and weaknesses. Its strengths are, among others, high technology standards and benign labor-management relations. When it comes to weaknesses, low profitability and lack of entrepreneurship stand out.

(Prowess of Corporate Japan)

Japan is renowned for high levels of technology development. International comparison of R&D expenditures in relation to GDP shows that, though falling behind Finland and Sweden, Japan outspends the U.S., Germany and other major advanced countries (see Figure 1). Much of R&D expenditures in Japan is undertaken by private businesses and Corporate Japan prides itself on its technological prowess.

The sectoral data on R&D are not available, but a reasonable guess is that Japan's manufacturing sector contributes much to higher R&D spending. Japanese manufacturers are traditionally export-oriented and competitive in global markets. Although over the past decades manufacturing has steadily been declining in importance in the economy and the service sector on the rise, it still produces the largest share of GDP among major advanced countries. Among Japan's top ten largest firms are five manufacturers; Toyota,

Figure 1 R&D Expenditures in Major Countries

(Source) OECD, "OECD Science, Technology and R&D Statistics".

Japan Tobacco, Honda Motor, Cannon and Fanuc (see Table 1). Those manufactures and the likes of Nippon Steel & Sumitomo Metal, Hitachi, Sony and Toshiba are the epitome of Japan's industrial prowess. Manufacturers along with telecommunication firms most likely are driving forces for technology investment to stay competitive. In comparison, IT-related firms like Apple, Microsoft, IBM and Google feature prominently among American biggest firms. In Japan, IT-related firms are mostly hardware producers and software firms are conspicuously missing in its large firm sector.

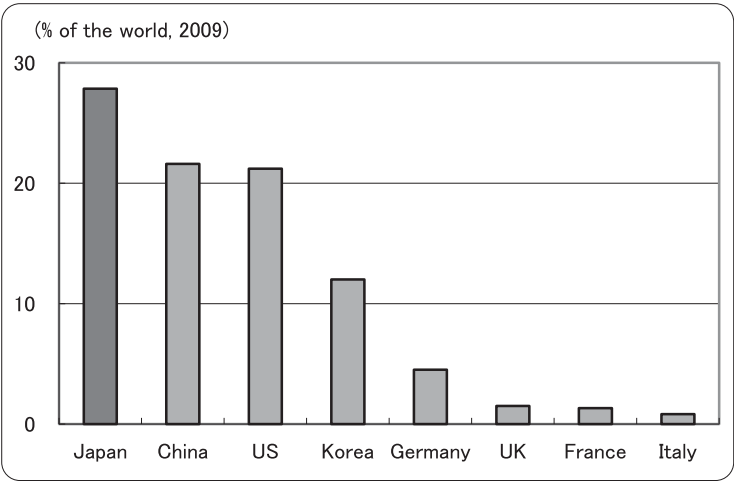
Another sign of Japan's technological might is copious patent applications. In 2009 patent applications by residents (mostly firms) in Japan were indeed the highest in the world, accounting for nearly one third of the world's total (see Figure 2). One qualification to this statistic is that it measures only the quantity or the number of patent applications but not their quality or technological significance. A case in point is China where patent applications have been hugely expanding in recent years and in 2009 they outnumbered those filed by US residents. Given China's current developmen-

Table 1 Top 10 Biggest Firms in Japan and the U.S.

	Japan	U.S.
1	Toyota	Apple
2	NTT DoCoMo	Exxon Mobile
3	Mitsubishi UFJ Financial	Microsoft
4	Japan Tobacco	Wal-Mart Stores
5	Honda Motor	General Electric
6	Softbank	IBM
7	Sumitomo Mitsui Financial	Chevron
8	Canon	Berkshire Hathaway
9	Mizuho Financial	AT&T
10	Fanuc	Google

(Source) FT Global 500.
(Notes) Market capitalization at September 28, 2012.

Figure 2 Patent Applications in Major Countries



(Source) The World Bank, “World Development Indicators & Global Development Finance”.
(Note) Patent applications filed by residents in each county.

tal stage, however, plentiful patent applications by Chinese residents are likely to be of low quality. Another qualification to the data is that some firms do not apply for patents for their top-rated innovations and instead keep them in-house as trade secrets. For all the limitations of the patent statistic, Japan's very active patent applications each year is indicative of its technology-savvy corporate sector.

The second advantage of Corporate Japan is amicable labor-management relations. In the 1950s through the 1970s, the relationship between socialist-minded labor unions and corporate managers was rather confrontational with a rash of labor strikes erupting across the country. As socialism started losing its shine across the globe, labor disputes have since decreased significantly. By international standards, Japanese firms are now least disrupted by labor disputes. In particular, the number of working days lost due to labor disputes in Japan is by far the lowest among major advanced countries (see Table 2). In Japan, labor disputes leading to the loss of working days occur only at small firms and larger firms look all but immune from them.

Labor unions in Japan are predominantly enterprise-based unions, formed along corporate rather than industry or occupation lines unlike in the U.S.

Table 2 Labor Disputes in Major Countries—Working Days Lost per Year—
(Thousands days)

Japan	16
US	5,071
Germany	156
France	1,055
UK	659
Italy	951

(Source) The Japan Institute for Labor Policy Training "Data Book: International Comparison on Labor 2012".

(Notes) Average of 2000-08. Note that if one hundred workers go on strike for two days at a firm, the number of working days lost is 200.

and Europe. For example, in America, the United Auto Workers (UAW) represents workers of the country's automobile industry. In Japan, Toyota has its enterprise union and likewise Honda has its own. Industry-wide and national labor federations do exist, but they are largely loosely-tied groups of independent-minded enterprise unions and do not engage in collective bargaining or strikes. The enterprise-based nature of unions tends to make union leaders to be more considerate of their firms' financial conditions in collective bargaining, resulting in less antagonistic, cooperative labor-management relations. Particularly, as economic weaknesses have persisted since the bust of the bubble economy, unions have taken priority in ensuring job security rather than demanding higher pays, much less going on strikes, out of fear that aggressive demands could threaten the viability of their own firms.

Another reason for the recent tranquil labor-management relations is the perennial fall in union membership, a clear sign of the decline in trade unionism in Japan. Unionization rate or the share of union-member workers to total workers has long been in decline. It was only 18.5% in 2010, down from 25.2% in 1990 and over 50% in 1950⁽¹⁾. Traditionally, unionists used to be limited to regular, mostly male workers. As non-regular workers such as part-timers and fixed-term workers have significantly been increasing at workplaces, some unions have been wooing non-regulars to make up for the decline in regular-worker members.

(The Achilles heel of Corporate Japan)

Low profitability and paucity of entrepreneurship are arguably the most important weaknesses of Corporate Japan.

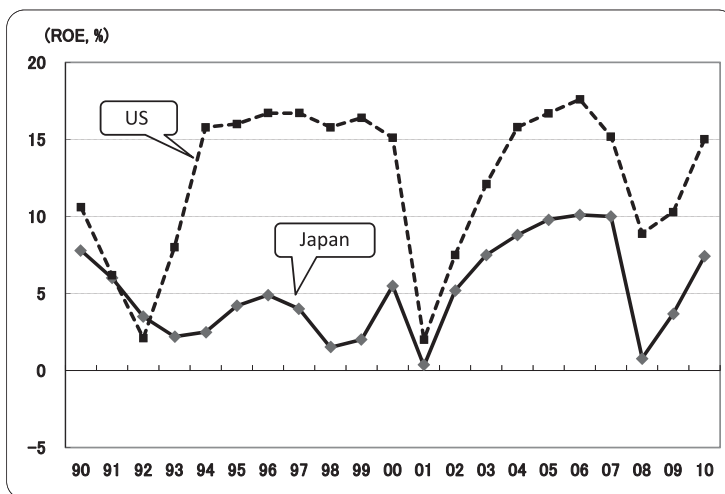
Start with lackluster profit performance of Japanese firms. Return on equity (ROE) and return on assets (ROA) are standard yardsticks for corpo-

(1) For comparison, unionization rate in other major countries in 2010 was 11.4% in the U.S., 18.5% in Germany, 7.6% in France (2008), 35.1% in Italy, and 26.5% in the U.K. Nordic countries had much higher unionization rate; 68.4% in Sweden, 54.8% in Norway, and 70.0% in Finland. The decline in union membership over the past decades is observed in other major countries as well.

rate profitability. ROE is the ratio of profits to shareholders' equity, gauging how well or poorly shareholders are rewarded for their equity contributions, while ROA is the ratio of profits to the firm's assets, measuring how well or poorly the assets are used in generating profits. By either measure, Japanese firms have not stacked up well by international standards.

Figure 3 shows that Japanese firms have been much less profitable than American firms over the past two decades. The updated data on average corporate profitability across countries are hard to come by, but earlier studies by Japan's Cabinet Office and staff of the Bank of Japan showed that Japanese firms were less profitable than major European countries as well as the U.S.⁽²⁾ Needless to say, some Japanese firms are very profitable and oth-

Figure 3 Profitability of Firms in Japan and the U.S.



(Sources) The Financial and Economic Research Institute of Nomura Securities "Business Performance Outlook for fiscal 2012-13" (for Japan). The Council of Economic Advisors to the President "The Economic Report of the President 2012" (for the U.S.).

(Notes) Returns are after corporate income taxes. Japan's data are for fiscal years.

(2) Cabinet Office of Japan (2006) and Kameda and Takagawa (2003).

ers are not. All that the data tell is that public firms or listed ones in Japan are, on average, underperforming.

Why are Japanese firms underperforming? The short answer is that shareholders' pressure on managers to raise profits have been weak. The long answer requires delving into three factors weakening pressures from shareholders.

The first such factor is cross-shareholdings which are a traditional business practice in Japan. The shares of many Japanese firms, particularly large ones, have been mutually held among themselves. Since a sizable portion of a firm's shares is held by "friendly" firms and the object of cross-shareholdings is to cement mutual relations and not to earn profits, the managers of cross-held firms are not hard pressed to raise higher profits. The origin of cross-shareholdings and their recent important changes will be discussed later. In addition, Japanese institutional investors like pension funds, insurance companies and mutual funds used to be "silent" shareholders who have just rubber-stamped proposals by managers at annual shareholders meetings.

Second, Japan's bank-based corporate finance is likely to lead to lower corporate profits. Until the late 1980s equity finance had been very rare, and larger firms have since started raising funds by issuing equity instruments including convertible bonds and warrant bonds. Still, bank loans remain a major source of funding for most firms. Banks' main interest is to make sure that borrower firms pay interest and repay debt, and they have little incentive to pressure firms to raise profits as long as firms service debt on schedule. Higher profits may not benefit banks because, first, they do not share bumper profits unlike shareholders and, second, demanding higher profits may engender higher risks which banks dislike most. By contrast, shareholders are residual claimants who are entitled to claim all after-tax profits so that they have strong incentives to exhort managers to raise profits as much as feasible.

Third, Japan's corporate governance is another likely cause for low profitability. At issue are how the boards of directors are structured and how top

managers are selected. Until recently, the boards of directors at the majority of Japanese firms did not include outside directors or non-executive directors who are expected to better represent the interests of shareholders and keep managers in check. Now many firms have started to appoint outside directors, but outside directors still are a tiny minority. Outsider directors are often invited from affiliated firms and banks so that they are not quite independent from managers. The obvious contrast is with America where most board members are independent outside directors. The upshot is that Japanese-style boards are unlikely to pressure managers to raise profits as much as boards occupied by many independent board members..

In addition to weak pressure from shareholders, the selection of managers likely is a contributory factor for low profits. In Japan, CEO (chief operating officer) and other executives are more often than not chosen from long-serving employees spending all adult life at the same firms. Such internal executives are the norm and external executives recruited from outside of firms are the exception. Internal executives have obvious advantages. They know nuts and bolts of their firms' operations very well. They may also have some positive effects on workers' moral, because executives are perceived "one of us" and internal promotion provides workers with a strong incentive to work hard to climb up the corporate ladder. A pitfall is that internal executives may likely consider themselves as heads of colleague workers rather than agents of shareholders whose primary job is to serve shareholders by making firms profitable.

As many Japanese firms now go global, tapping the global talent pool has become increasingly important to manage multinational operations and raise profits globally. Nevertheless, foreign managers account for only 2% of managers at Japanese firms with overseas sales topping 50% of total sales. In contrast, this ratio is 20% in the EU and 17% in the U.S.. The startling paucity of foreign managers at Japanese multinationals likely reflects Japan's traditional, die-hard practice of internal promotion. Poor English language skills of Japanese workers and managers may be another reason, for recruit-

ing foreign managers would create communication problems inside firms.

For all the problems behind low profitability, traditional features of Corporate Japan have been changing in many ways. In particular, cross-shareholdings have recently been unwinding and the keiretsu system, closely-tied groups of firms, has been eroding, as will be discussed later. Calls for strengthening corporate governance has now been heeded by corporate leaders and policymakers, and active and sometimes vociferous shareholders have been on the rise. The hope is that underperforming firms will become more profitable as Corporate Japan continues to transform itself.

Another major weakness of Corporate Japan is lack of entrepreneurship. An aging Japan sorely needs a vibrant growing economy creating higher incomes to support the elderly. Whereas active entrepreneurial activities are a key to vitalizing an economy, entrepreneurship in Japan has long been in a sorry state. In recent years, the need to foster entrepreneurship has been much underscored and there appear some signs of change for the better. Since lack of entrepreneurship is closely intertwined with culture, education, and business laws and practices, however, bucking the adverse trend is no easy task. The issues of entrepreneurship will be discussed in detail later.

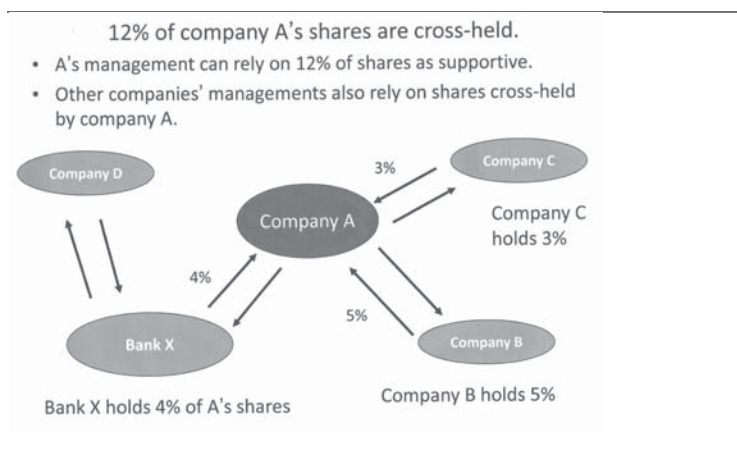
2. The Rise and Fall of Cross-Shareholdings

Corporate Japan has been undergoing significant changes in recent years. Cross-shareholdings and the keiretsu once stood out as unique features of Japan's corporate world. Both features used to be either much touted or berated, but more recently have become increasingly less pronounced. As old traditions wane, some new trends have been emerging. Foreign ownership in Japanese firms was as rare as hen's teeth only two decades ago, but is now as common as eggs laid by hens. As with foreign ownership, M&A (mergers and acquisitions) used to be uncommon, but now one could hardly read Japanese newspapers every morning without finding reports on some M&A cases. Those fading traditions and new trends are next topics.

(The genesis of cross-shareholdings)

Begin with cross-shareholdings, which mean a situation where firms mutually hold their equity shares often among the same keiretsu group firms. Figure 4 illustrates how cross-shareholdings work. The shares of Company A are held by Company B, Company C and other firms as well as Bank X. Reciprocally, Company A holds shares of those firms and Bank X. Typically, banks play a linchpin role in cross-shareholdings⁽³⁾. The objective of holding shares of other firms is not an equity investment to earn dividends and capital gains, but rather to secure “stable” shareholders who always vote for managers’ proposals at shareholders’ meetings and to cement friendly relationship among like-minded firms. For example, if some investor tries to launch an hostile takeover bid to Company A or to garner votes against reelection of CEO and other executives, mutually-held shareholders like B, C and X would help block such moves.

Figure 4 An Image of Cross-Shareholdings



(3) The banking regulations in Japan prohibits a bank from owning more than 5% of the shares of one firm. Its aim is to prevent the dominance of banks over non-bank firms. It should be noted, however, that equity holdings by Japanese banks, particularly large ones, are quite substantial because they hold shares of many firms.

Cross-shareholdings used to be much touted in this country in that managers could focus on long-term corporate management without falling victim to short-termism often driven by vocal, demanding shareholders. The danger, however, is that weak pressure and inadequate monitoring on managers by shareholders would not drive managers to run the firm most efficiently and profitably even in the long run. In other words, the principal-agency problem, that is the inherent difficulty in aligning the incentives of managers (agents of shareholders) with those of shareholders (principals), risks lowering corporate profitability. Add to this, a cross-shareholding firm would earn low profits because the shares of underperforming group firms in its assets would not yield much returns. All in all, cross-shareholdings are likely to have been one of main causes for low profitability of Japanese firms.

The genesis of cross-shareholdings was Japan's accession to the OECD in 1964. One of the conditions for Japan to join the OECD was to liberalize, in stages, foreign investment in the country in line with the OECD's economic liberalization agenda. For fear of being taken over by large, powerful Western firms, Japanese firms started cross-shareholdings in the late 1960s. Incidentally, Chrysler's purchase of a venerated French carmaker called SIMCA sent a shock wave among Japanese corporate leaders. Cross-shareholdings did not require new fund to boost the capital base, because a firm issued new shares to a partner firm through private placements and then used the acquired fund to purchase new shares issued by the partner firm. It was as if firms had used alchemy to raise shareholders' equity⁽⁴⁾.

Two decades on, another wave of cross-shareholdings came in the late 1980s when large firms shifted their funding from traditional bank loans to equity finance as the stock market turned buoyed. Banks facing the decline

(4) There were some other factors for the start of cross-shareholdings. The sharp decline in share prices in the middle of the 1960s led to a massive cancelation of mutual funds by individual investors. Since many firms relied on mutual funds and other institutional investors as "stable" shareholders, they wanted to secure other stable shareholders to fend off hostile takeovers. In addition, thanks to the relaxation of the conditions on private placements in 1966, managers could assign new shares to related banks and firms which were expected to become stable shareholders.

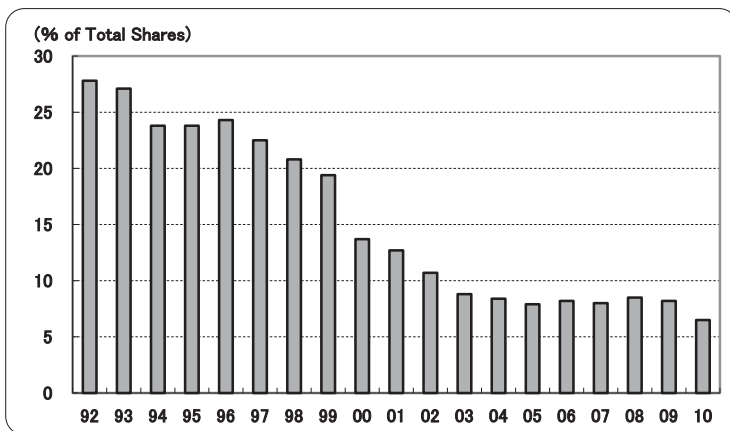
in loan demand purchased part of the shares issued by their client firms. As a result, equity holding in banks' portfolio rose further and banks became even more important in cross-shareholdings.

(Cross-shareholdings fast unwinding)

The tide has turned notably since the late 1990s, with firms and banks starting to unwind cross-shareholdings (see Figure 5). What caused the unwinding of cross-shareholdings? While a couple of changes in government regulations prodded firms and banks to sell off their cross-held shares, the primary cause was the bubble bust and its fallout.

First, during the protracted economic stagnation after the bubble bust at the beginning of the 1990s, many firms suffered losses with their sales sagging, and banks saw profits disappearing thanks to piles of bad debt. One way for firms and banks to make up for operational losses was to sell off their cross-held shares. The cross-held shares acquired a few decades earlier contained unrealized capital gains since their purchase prices or book values

Figure 5 Unwinding Cross-Shareholdings



(Source) Daiwa Institute of Research "Estimates of the Structure of Cross-Shareholdings 2010".

(Note) The data are for listed companies at the end of March each year.

were much lower than their market values. Accordingly, firms and banks could manage to post profits or reduce losses by turning “hidden” profits from equity holdings into “real” profits.

Second, the government adopted in 2001 the mark-to-market accounting rule which had become a new global standard for corporate accounting, ditching the antiquated historical-cost accounting rule. Under the previous historical-cost-based bookkeeping, firms and banks did not have to reveal unrealized capital gains and losses. As stock prices kept sliding in the 1990s through the early 2000s, much of unrealized capital gains from cross-held shares had evaporated, turning into substantial unrealized losses. With the new accounting rule in place, firms and banks could no longer keep such losses hidden. They were keen to sell off cross-held shares before capital losses would further rise.

Third, a change in banking regulations also played a major role in reducing cross-shareholdings. In the wake of the financial crisis erupted in 1997, the government decided to introduce a cap on a bank’s equity holdings below its bank capital, but at that time big banks had equity holdings one-and-half or two times their bank capital. In particular, a new law enacted in 2001 required banks to meet this limit to their equity holdings by 2006. The new banking regulation prompted banks to further offload their equity holdings, and firms whose shares were sold by banks in turn sold off the shares of banks. As a result, cross-shareholdings were unwound furthermore.

It is worth noting that unwinding of cross-shareholdings was not in fact the aim of the new banking regulation but rather a collateral byproduct. The new rule was part of the government’s effort to stabilize banks’ financial conditions. Under the internationally-agreed Basel rules for bank capital adequacy, Japanese banks were allowed to count part of unrealized capital gains from their equity holdings as bank capital⁽⁵⁾. Note that the Basel rules require banks to hold sufficient bank capital as cushion to fend off bank failures. As previously noted, Japanese banks were central players in cross-shareholdings, owning huge amounts of stakes of group firms. When the

stock market was strong, Japanese banks could claim they were well-capitalized, but when the stock market got weaker they turned under-capitalized. In particular, during the post-bubble era when share prices continued to go south, Japanese banks got into a predicament as their capital base eroded. In the early 2000s, the government fighting the fallout from the financial crisis decided to order banks to reduce their equity holdings below their shareholders' equity in an attempt to stabilize banks' financial conditions. Whatever the intention of bank regulators, the new bank regulation on banks' equity holdings has led to a further decline in cross-shareholdings.

In sum, cross-shareholdings used to be a hallmark of Corporate Japan, but is no longer as important⁽⁶⁾. To the extent that cross-shareholdings are unwound, Japanese managers are likely to face heavier pressures from return-conscious shareholders to lift up profitability.

3. The Legendary Keiretsu

(What is the keiretsu?)

A salient feature of Japan's corporate sector, which is closely related with cross-shareholdings, is the keiretsu. The keiretsu are groups of firms connected with close business relationships and mutual shareholdings. While there could be scores of keiretsu groups depending on how keiretsu is defined, the prototypical and most important ones are the big six or the six

(5) Counting unrealized capital gains as part of bank capital has been applied only to Japanese banks. When the Basel rules were first put into place in 1988, this Japanese-specific rule for unrealized capital gains was introduced at the request of the Japanese government. At that time, Japanese banks had large unrealized capital gains from their equity holdings so that this rule made them well-capitalized. Ironically, as the stock market started a long descending path since the beginning of the 1990s, banks' unrealized gains turned to large unrealized losses and thus their bank capital got thinner and thinner.

(6) More recently in 2007, Japan's three top steel makers (Japan Steel, Sumitomo Metal, and Kobelco) agreed to hold their shares mutually as part of efforts to promote business alliance. This cross-shareholding arrangement reportedly was meant to ward off a potential takeover bid by Arcelor Mittal Steel, the world largest steel maker. It should be noted, however, that such a new development has not altered an overall picture of the declining cross-shareholdings in Japan. In 2012, Japan Steel and Sumitomo Metal eventually merged into a new Japan Steel and Sumitomo Metal.

biggest keiretsu; Mitsubishi, Mitsui, Sumitomo, Fuyo, Sanwa and Daiichi Kangyo⁽⁷⁾. The keiretsu are a unique Japanese institution of business organization, and in fact there are no western counterparts to the keiretsu.

The origin of those keiretsu dates back to the powerful *zaibatsu* or family-owned conglomerates that dominated the Japanese economy until the end of the world war II. Condemning the *zaibatsu* as accomplices of the Japanese military in venturing into a war of aggression, the American Occupation Force ruling Japan for several years after the country's defeat disbanded all *zaibatsu* groups and the vast wealth of the owner families was virtually confiscated. Once the Occupation Force left Japan, member companies of the biggest *zaibatsu* started regrouping as new keiretsu groups⁽⁸⁾. Unlike the pre-war *zaibatsu* that were close-knit groups of big firms controlled by the family-controlled holding companies, the post-war keiretsu have neither dominant owner families nor holding companies, and are more loosely connected groups of firms.

Top executives of each big six meet monthly to exchange information on their businesses and some broader issues in respective "presidents' club" lunch meetings. For example, the presidents' club of the Mitsubishi group meets on the second Friday of each month. The presidents' club member firms are large venerated firms representing most major industrial sectors like finance, trading (*sogo shosh* or general trading companies unique to Japan), steel and other heavy metals, chemical, electronics and automobiles. Among them, a big bank (commercial bank) in each group used to play central roles in connecting its group firms. Besides the presidents' club member

(7) A broader definition of the keiretsu includes horizontal keiretsu (sometimes called financial keiretsu) and vertical keiretsu. The big six are the most important ones among horizontal keiretsu in which firms of different industrial sectors get together. An archetypal example of vertical keiretsu is the Toyota group in which Toyota at the apex and a host of suppliers of auto-parts and materials maintain close business relations.

(8) The Mitsubishi group grew out of the Mitsubishi *zaibatsu*, the Mitsui group out of the Mitsui *zaibatsu*, the Sumitomo group out of the Sumitomo *zaibatsu*, and the Fuyo group out of the Yasuda *zaibatsu*. The Sanwa group and the Daiichi Kangyo group had weaker roots in pre-war *zaibatsu* groups and included no firms with common names unlike the other four groups.

firms, smaller firms having close relations with them are often considered as part of the keiretsu. One caveat is that no membership lists of the keiretsu exist, save the rosters of presidents' clubs. Therefore, which firms and how many firms are included in, say, the Mitsui group is indeed ambiguous.

This is how the archetype of the keiretsu is thought to work. First, Keiretsu group firms trade with each other. Such intragroup trade is one way to maintain close business ties. Second, much of its financial needs are met by the keiretsu's commercial bank as a "main bank", coupled with other financial institutions like trust banks and life and non-life insurance firms⁽⁹⁾. Third, group firms mutually hold shares among themselves with the aim of fending off hostile takeover attempts by outsiders, notably foreign firms. Fourth, when a group firm gets into a pickle, the group's commercial bank acting as its main bank rescues it with ample lending and often sends bank staff as its executives to manage its cost cutting and other restructuring efforts. In short, the keiretsu provide group firms with insurance against financial distress.

(The Myth of Japan Inc.)

The keiretsu had been an important factor in Japan's corporate sector for the better part of the post-war period, although how important is subject to debate among researchers. Since the bursting of bubbles, the keiretsu appear to have started declining in importance. When Japan wowed the world with near-10% annual growth during the 1950s and 1960s and later with the skyrocketing stock market and aggressive investment abroad in the late 1980s, the keiretsu were, all too often, viewed as powerful business machinery that was nurtured and protected by the Japanese government and dominated Japan's economy. A case in point is a popular concept of "Japan

(9) A commercial bank which is a major lender for a firm is called a main bank for that firm. A main bank maintains close ties with its client. Non-keiretsu firms also have their own main banks. The main bank system is often viewed as one of peculiarities of Corporate Japan. A trust bank, which is unique to Japan, operates mainly as a trust company but offers commercial banking services as well.

Inc.” in which Japan’s government and businesses, particularly the keiretsu firms, cooperate hand in hand in promoting economic development, and even collude in excluding foreign firms in domestic markets and invading foreign markets. Amid the U.S.-Japan “trade war” in the 1980s, the U.S. government irritated by large U.S. trade deficits vis-a-vis Japan and the alleged onslaught of Japanese investment in the U.S. pressed the Japanese government to remove structural impediments for foreign businesses in expanding exports to Japan⁽¹⁰⁾. The keiretsu were one of the contentious issues, with the U.S. claiming that the closed nature of the keiretsu was hampering foreign businesses from doing business in Japan.

The role of the keiretsu in the Japanese economy in the eyes of the westerners, not least Americans, is overrated, however. Here is why. First, if, in fact, the keiretsu groups enjoyed favorable treatments by the government and unfairly blocked non-keiretsu firms from doing business with them, one would expect that they would rake in fatter profits than non-keiretsu competitors. Yet, empirical studies have shown that the profitability of keiretsu firms were no higher than that of non-keiretsu competitors. Second, statistical perusal of keiretsu firms’ transactions indicates that intragroup trade was not as much as one would expect once trades between a group’s trading firm (sogo-shosha) and other group firms are excluded, and that banks of any keiretsu groups were large lenders to big firms outside their own groups as well. Third, it is true that banks, particularly big banks at the center of the keiretsu, had been heavily protected and their competition had been restricted in a so-called convoy system until the 1990s. The convoy system referred to the modus operandi of Japan’s financial regulators that banks and other financial institutions were bunched together to sail along under heavy government protections like a gunship-protected convoy in a wartime. Whereas such policies of protection coupled with stifled competition had led

(10) Upon the request of the U.S., Japan and the U.S. conducted a series of negotiations called the structural impediment initiative in 1989-90.

to the stability in the banking sector for several decades after the world war II, they had resulted in not only a calamitous financial crisis in the late 1990s but also the loss of international competitiveness of Japanese banks.

(The keiretsu fading away)

Controversial as the role of the keiretsu in its heyday may be, the keiretsu have recently been notably receding. As discussed earlier, cross shareholdings have been rewound rather significantly over the past two decades. Holding mutually the shares of firms of the same keiretsu group was an important tool to bind group firms together. Now the binding tie has been fraying.

Another reason for the weakening of the keiretsu is a seismic change in banks. The landscape of Japan's banking sector has transformed dramatically and the six commercial banks that were at the center of the big six have merged into three mega banks during the past two decades, altering the nature of the keiretsu. Mitsubishi Bank of the Mitsubishi keiretsu, Sanwa Bank of the Sanwa keiretsu and other few big banks have merged into Tokyo-Mitsubishi UFJ Bank that is the core firm of the Mitsubishi UFJ Financial Group. Sumitomo Bank of the Sumitomo keiretsu and Mitsui Bank of the Mitsui keiretsu have become Sumitomo-Mitsui Bank, the core firm of Sumitomo Mitsui Financial Group. Lastly, Fuji Bank of the Fuyo keiretsu, Daiichi Kangyo Bank of the Daiichi Kangyo keiretsu and another big bank have teamed up to create Mizuho Bank, the core firm of Mizuho Financial Group.

Thanks to the recent convoluted amalgamation of big banks, the cohesiveness of the keiretsu groups, if any, has evidently weakened. For example, now Tokyo-Mitsubishi-UFJ Bank, the country's largest mega bank, is a member of both Mitsubishi keiretsu and Sanwa Keiretsu, and likewise Sumitomo Mitsui Bank, another mega bank, is a member of both Sumitomo keiretsu and Mitsui keiretsu. To make matters even more complicated, Sumitomo Mitsui Trust Bank, a merged bank of Sumitomo Trust Bank and Mitsui Trust Bank,

is now a member of Sumitomo keiretsu and Mitsui keiretsu just like Sumitomo Mitsui Bank, although it has no business ties with Sumitomo Mitsui Bank. In fact, Sumitomo Mitsui Trust Bank and Sumitomo Mitsui Bank belong to two rival financial groups; Sumitomo Mitsui Trust Holdings and Sumitomo Mitsui Financial Group.

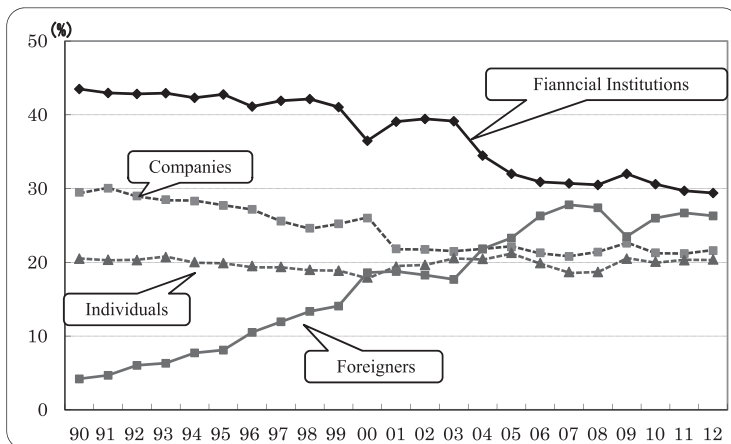
As with the mergers of big banks, mergers of non-bank firms, which have been on the rise, could significantly affect the membership of the keiretsu. A case in point is Nippon Steel & Sumitomo Metal, one of the world's largest steelmaker. In 2012, Nippon Steel which did not belong to any keiretsu groups, and Sumitomo Metal, a key member of Sumitomo keiretsu, merged to cope with the ever-intensifying global competition in the world's steel industry. The new-born Nippon Steel & Sumitomo Metal parted with Sumitomo keiretsu.

In sum, the keiretsu have become much less prominent over the past two decades or so. The big six keiretsu groups still do exist and the top executives of member firms continue to meet in each group's monthly "presidents' club" meetings. Yet, the keiretsu today are unlikely to affect the course of the economy, or any particular industry for that matter, and does not collude to block foreign firms from doing business in Japan.

4. Emerging Trends in Company Ownership

(Foreigners owning a quarter of Corporate Japan)

One of remarkable changes in corporate ownership in Japan over the past few decades is the rise in foreign shareholders (see Figure 6). Back in 1990, foreign ownership accounted for meager 4.2% of all the shares of Japanese firms listed in the stock market. Foreign investors have since increased their stakes steadily, and now they own about one fourth of Corporate Japan (26.3% in 2012). This is an average picture, and in fact some firms look well-liked by foreign investors. Likes of Hoya, Yamada Denki, Orix, Mitsui Fudosan, Kao, Sony and some more have foreign ownership of above or close to 50%. Foreign investors are mostly institutional investors like pension funds,

Figure 6 The Structure of Company Ownership

(Source) Tokyo Stock Exchange “Survey on Share Ownership, Fiscal 2011”.

(Note) At the end of March each year.

mutual funds and insurance companies.

What factors have brought about the rise in foreign ownership? First, as the share prices have declined so much since the beginning of the 1990s that Japanese shares have become an attractive investment opportunity for foreign investors. Second, institutional investors worldwide has increasingly gone global since the 1990s, actively investing in foreign securities. As part of international diversification of their portfolios, institutional investors abroad have increased their stakes in Japanese firms. The third, if not least important, factor is the unwinding of cross-shareholdings. As many Japanese firms and banks offloaded their cross-held shares as discussed earlier, foreign investors bought up those shares.

Traditionally, Japanese shareholders, most notably cross-held shareholders, used to be undemanding or even lethargic when it came to their relations with managers. By contrast, foreign investors tend to be more return-conscious and more vocal. As foreign ownership has expanded, managers are now paying greater attention to shareholders' interest, focusing on

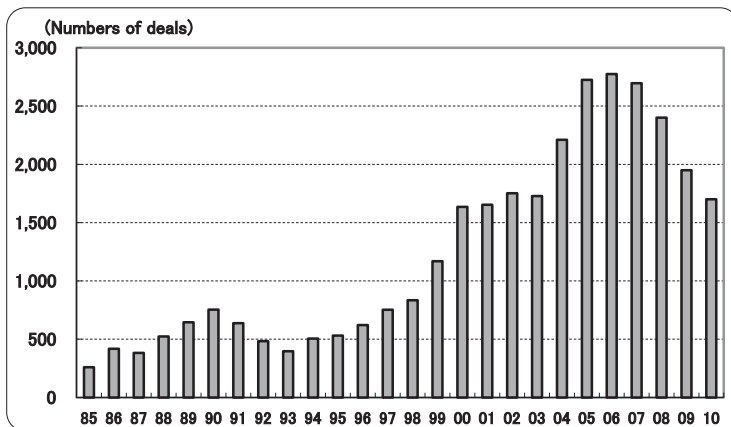
value for shareholders, or simply put, making their firms profitable. There have also been important changes in the behavior of Japanese institutional investors, turning more vocal in getting managers to focus on value for shareholders. It is no longer a rarity that they vote against the managers' proposals on executive pays, reappointment and other matters at shareholders' meetings. Some of them now publicly request firms to set and announce a target for profitability in terms of ROE. If a firm falls short of its profitability target for multiple periods, they would vote against reappointment of managers or just sell off its shares.

(M&A on the rise)

Another emerging trend in Japan's corporate world is the rise in M&A activities over the past decade and a half. Since M&A entails changes in company ownership, active M&A has led to greater flexibility in company ownership. M&A used to be very rare events in Japan, but it has now become an increasingly important tool of strategic corporate management. It was since the late 1990s when M&A activity has started to surge markedly (see Figure 7). Whereas M&A declined from 2008 when the global financial crisis broke out, its annual levels stayed far higher than that in the 1980s and 1990s and it has already started recovering since 2011. The majority of M&A cases have been in-in M&A (between Japanese firms), but in-out M&A (Japanese firms acquire foreign firms) and out-in M&A (foreign firms acquire Japanese firms) have also been on the rise.

Both government actions and changes in economic environments have led to the rising trend in M&A. First, the government has deregulated various measures inhibiting flexibility in corporate restructuring and expansion. Much of important deregulation in this regard took place in the late 1990s through the early 2000s.

One such important case was the lifting of the long-standing ban on holding companies. For a large firm operating in different lines of business, it is often more efficient to organize a corporate structure in which a holding

Figure 7 Active M&A in Japan

(Source) RECOF “M&A Data”.

company takes control of subsidiary operation firms. Nevertheless, setting up a holding company had long been prohibited by the country’s antitrust law over a half century⁽¹¹⁾. The ban was lifted in 1997 (in 1998 for financial institutions) as part of reforms on corporate laws. This change has indeed had far-reaching impacts on how Japanese firms are organized and operate. Many large firms are now reorganized as company groups headed by holding companies. To mention only a few, such recently-reorganized firms include AEON (supermarkets), NTT (telecommunication), Kirin (beverages), DNH (printing) and all of largest banks and security firms (investment banks). The list of examples could be all but endless. There have been many instances where holding companies shed off their subsidiary operation firms to cut losses or buy up other firms and add them as new subsidiary operation firms.

Other government measures include the simplification of merger procedures (1997), the relaxation on merger payment methods (1999 and 2007), and

(11) The U.S. occupying Japan after the world war II ordered Japan to prohibit the holding company system by the newly-instituted antitrust law. Its aim was to prevent the revival of the disbanded zaibatsu. Note that a holding company of each zaibatsu controlled its group firms.

the streamlining of taxation regarding merger and restructuring (2001). As for merger payments, firms buying other firms used to be required to pay cash to the shareholders of the merged firms. Now they could make payment by assigning their own new shares to the merged firms' shareholders. This and other deregulation measures have brought about greater flexibility in M&A activities.

With various government measures facilitating M&A activity put into place, changes in economic conditions have led to the rise in M&A. First, the protracted stagnation during the lost decade deteriorated business conditions, resulting in a surge in bankruptcy. Many firms struggled to survive and restructuring (called *risutora* in Japan) became a buzzword of the time. Active corporate restructuring led to a rise in M&A. Second, increased global competition has been a major contributory factor for surging M&A. As many Japanese firms go global, they often have acquired foreign firms to expand their operations rather than setting up new foreign subsidiaries from scratch, because speed rules the day in global competition. M&A is in effect a means to buy time when it comes to entering a new market either domestic or abroad.

Against the backdrops of government measures and economic conditions, M&A has now become a standard tool for conducting businesses in Japan and therefore is likely to continue to rise. To date, a majority of M&A cases has been friendly takeovers where managers of both acquiring and target firms agree on merging. In this country, the general perception remains that a hostile takeover where managers of a target firm are against a merger proposal by a potential acquirer is loathsome and even unethical. Recall that cross-shareholdings started as a means to ward off hostile takeovers by foreign firms. Contrary to the popular view, a hostile takeover could be beneficial for the shareholders of a target firm and could even be good for the economy if the acquiring firm improves the performance of the merged operations. With M&A becoming commonplace, some firms wary of hostile takeovers have introduced defensive measures such as poison pills. However,

overly defensive measures would harm the performance of firms since inept, underperforming managers would be shielded from the threat of being replaced. The best way for managers to forestall any hostile takeover is to raise profitability of their firms and thereby keep the share prices higher.

In this regard, a takeover bid in 2006 by Oji Paper to purchase Hokuetsu Paper (now Hokuetsu Kishu Paper) was of particular importance. This was the first hostile takeover attempt by a major Japanese firm, and in fact Oji Paper was (and is) Japan's largest paper and pulp company. Until then, hostile takeover attempts had been made mostly by either foreign investors or small Japanese firms⁽¹²⁾. It is also worth noting that Nomura Securities, Japan's top investment bank, took on the role of financial advisor for Oji. Until then, Japanese securities firms tended to stay away from becoming a financial adviser for a hostile acquire. Although this takeover attempt failed since another big firm (Mitsubishi Corporation) sided with Hokuetsu and Oji could not coax Hokuetsu's shareholders to sell their stakes, it was an eye-opener for Japan's corporate world where a hostile takeover bid was widely regarded as some unsavory tactic of corporate raiders. While such misgivings die hard, M&A, friendly and hostile alike, has now come to be embraced as useful tools for corporate management.

Another new trend in corporate reorganization involving changes in company ownership is a rise in MBO (management buyout) over the past decade. A successful MBO attempt is the acquisition of a firm by its managers, often tied up with a buyout fund, and the managers become new owners of the firm. In Japan, MBOs had been almost non-existent until the end of the 1990s, and have since been significantly increasing. As with M&A, MBO is a useful tool for more flexible corporate management.

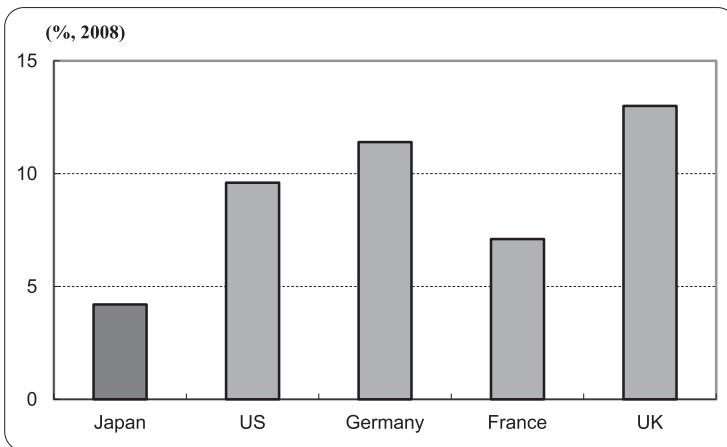
(12) Most notably, Steel Partners, an aggressive American hedge fund, has recently attempted unsuccessful hostile takeovers of several small firms. Notorious and much-detested as the fund is in Japan, it has inexorably driven the managers of target firms to improve their performance.

5. Fostering Entrepreneurship

(Dearth of entrepreneurial vim)

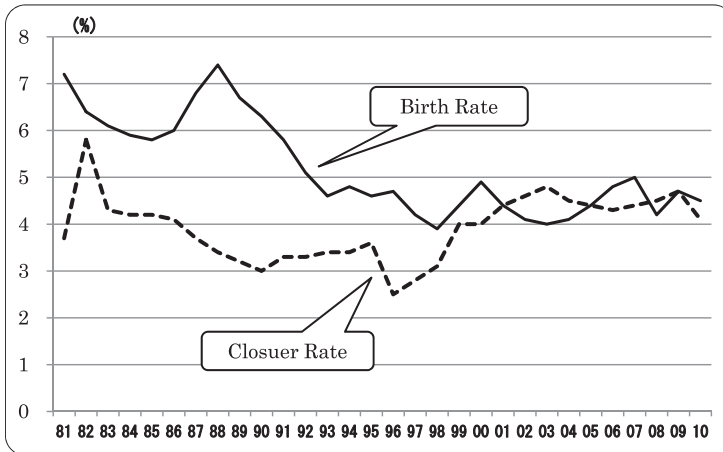
An obvious weak suit of Corporate Japan is that entrepreneurship is in short supply. In fact, a number of studies have shown that when it comes to entrepreneurship, Japan ranks markedly low among major advanced countries, let alone vibrant emerging market economies. One main indicator gauging the extent of entrepreneurial activity in a country is the birth rate of firms, or the ratio of new firms created in a year to the country's total existing firms. Corporate birth rate in Japan is far lower than in the U.S. and major European countries (Figure 8). And, add to this, its time-series data are also disappointing (Figure 9). The birth rate had been trending down until the end of the 1990s and has since stabilized at low levels. The closure rate, that is, the ratio of firms out of business in a year to the total existing firms, has been at roughly the same levels as the birth rate over the past decade. As a

Figure 8 Firm Birth Rate in Major Countries



(Source) EIM Business & Policy Research

(Note) The firm birth rate is the proportion of new firms established in a year to total firms

Figure 9 Sagging Entrepreneurship in Japan

(Source) The Ministry of Economy, Trade and Industry of Japan “The White Paper on Small and Medium-Sized Businesses 2012”

result, the total number of firms operating in Japan has largely stayed flat without much replacement of businesses. The state of entrepreneurship in Japan can be best likened to weakened metabolism of a living thing.

Cross-country survey studies have shown that young people in Japan have lower regards for entrepreneurs than other countries. They tend to respect more the likes of executives of large corporations, medical doctors and bureaucrats. This reflects the lack of entrepreneurial culture in Japan. People who do not look up to entrepreneurs are unlikely to be interested in starting their own businesses.

Japan was not always that wanting in entrepreneurship. Some of today’s biggest firms have grown out of tiny start-ups. To mention a few, Mr. Kono-suke Matsushita started Panasonic (formerly Matsushita Electric) in 1918. There emerged great entrepreneurs right after the world war II. Messrs. Akio Morita and Masaru Ibuka founded a small company growing into today’s Sony, and Mr. Soichiro Honda started Honda Motor. Mr. Momofuku Ando, the founder of Nishin Food, invented instant noodle at his humble home’s

backyard. Later he also invented cup noodle which has now become a household name in the world. Since those times full of entrepreneurial vim, however, entrepreneurship in Japan appears to have long been sagging over the past half century.

The following factors, which are obviously interconnecting, are likely responsible for Japan's lack of entrepreneurship.

First, business blowup entails onerous costs for entrepreneurs. If you borrow money from a bank for your start-up firm, more often than not you are personally liable for the firm's loan. Accordingly, a business failure leaves large debt you are personally liable to repay for many years to come. In addition to such financial costs, failed entrepreneurs suffer social stigma. When your business goes wrong, you may be regarded as reckless and useless.

Second, the lack or paucity of venture capital and angels is another reason. Venture capitals which provide risk money for start-ups are still limited, particularly in comparison with the U.S.. Moreover, Japanese venture capitals tend to fund new firms that have already some signs of success and shy away from new-born start-ups which are riskier than those in secondary stages. Their risk-averse investment behavior is due probably to the fact that most of them are subsidiaries of big financial institutions like banks, securities firms and insurance companies, and investment officers are often sent from parent financial institutions. Their salaried-employee mindset and the pay system which is often not quite performance-based may not be suited for the venture capital industry. The U.S. is renowned not only for the deep pockets of venture capitals but also for its fecundity of angels. Angels are successful entrepreneurs themselves and support other entrepreneurs not only with funding but also with advises based on their own experiences. In Japan, such angels are all but non-existent. The lack of angels and weak entrepreneurship are feeding on each other. Namely, Japan does not have many successful entrepreneurs so that Japan do not have many angels. The short supply of angels in turn results in the lack of successful entrepreneurs.

The third factor for Japan's sagging entrepreneurship is the lack of

entrepreneurial culture. As noted previously, the Japanese, notably younger ones, do not have a high opinion of entrepreneurs. Here again, the state of entrepreneurship and entrepreneurial culture are interrelated, feeding on each other. The lack of entrepreneurial culture would make entrepreneurial activities dormant, while entrepreneurial culture would not flourish in a country with few role models for future business starters.

(Aging and entrepreneurship)

Entrepreneurship is important for any country, but an aging Japan sorely needs to foster entrepreneurship. First, entrepreneurship brings vitality and innovations into an economy, boosting growth in the long haul. This is just what an aging Japan needs, because higher growth provides the wherewithal to support the elderly. Second, vibrant small businesses create jobs. Moving away from lifetime employment requires job markets that could absorb mid-career workers. In this regard, it is worth noting that most jobs are created by small businesses in the U.S. where entrepreneurial activities are vibrant. By contrast, in Japan, small firms are generally regarded as a sort of weaklings which need to be protected with a variety of government measures. As a result, with inefficient small firms being able to stay afloat, Japan's small business sector lacks vim and vigor.

Although entrepreneurship in Japan is sagging and bucking the trend is a daunting task, there have recently been some encouraging signs for change.

(1) Emergence of high-profile entrepreneurs

Some successful entrepreneurs have come to be widely known by the public through media reports and TV appearances. They are, among others, Mr. Masayoshi Son, the founder of SoftBank, now a large mobile phone company, Mr. Hiroshi Mikitani, the founder of Rakuten, who has made his firm Japan's biggest online retailer, and Mr. Miki Watanabe, the founder of Watami Food, who has now entered other businesses as well. Their visibility could help change the public's perception about entrepreneurs.

Sadly, however, there have been some disgraced heroes, most notably

Mr. Takafumi Horie. Mr. Horie, a college dropout, was a founder and CEO of a fast-rising internet firm and once seen as a champion of young entrepreneurs. He is now in jail for accounting fraud after losing a drawn-out court battle.

For all some setbacks, the hope is that young people start seeing entrepreneurs in a better light. Transforming Japan's entrepreneurial culture would require a variety of high-profile successful entrepreneurs to emerge.

(2) Finance for emerging firms

Two stock markets for start-ups and other emerging firms were created in around the beginning of the 2000s by Japan's then two biggest exchanges (the Tokyo Stock Exchange and the Osaka Stock Exchange). Note that the two exchanges merged in 2012. The aim of introducing those markets was to financially support emerging firms, supplying them with risk money. While Japan's stock markets for emerging firms are still in developmental stages, they offer alternative sources of funding other than bank loans and young and promising firms are now able to tap stock markets.

The venture capital industry has recently been growing. Venture capital firms now totaling about 50 often send board members and provide start-ups with managerial support as well as equity funding. As discussed earlier, Japan's venture capital industry is still small in size and plays a limited role in supporting start-ups, particularly compared with the U.S.. As venture capital firms gain expertise in identifying promising new firms, they hopefully will take on more important roles in fostering entrepreneurship financially and technically.

(3) Changes in corporate laws

Over the past decade or so, the government has introduced a number of changes in corporate laws which would encourage businesspersons to start new businesses. A new law for technology transfer organizations (TLO) was enacted in 1998 to promote university spin-offs and foster university-business collaboration. Legal measures to make it easier to start new businesses have also been introduced. One such measure was doing away with the minimum

of paid-in capital of 10 million yen in 2006. Now you can start a new firm with a small amount money at hand. Another step was a new law introducing limited liability partnership (LLP) in 2005. LLP is a unique form of business enterprise suitable for innovative start-ups. An entrepreneurial individual offers a LLP innovative technologies or ideas while investors (some firms or individuals) provide funding for the LLP. It can be flexibly determined how profits, if any, are allocated among the entrepreneurial individual and investors. LLP is, legally speaking, not a firm so that it does not have to pay corporate income taxes.

Bankruptcy laws providing for restructuring failed firms were revamped in 2000 and 2002. Bankruptcy laws used to be cumbersome and unwieldy so that smaller firms rarely filed for bankruptcy. With the new bankruptcy laws similar to America's Chapter 11 in place, bankruptcy filings have significantly risen. To the extent that it is easier and more expeditious to sort out a business failure and start all over again, it is easier to embark on a new business.

The changes discussed above will help foster entrepreneurship in Japan. More fundamentally, greater flexibility in the labor market and entrepreneurship education at high school and college levels are needed.

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