Japan's Network Economy

Structure, Persistence, and Change

JAMES R. LINCOLN
University of California, Berkeley

MICHAEL L. GERLACH
University of California, Berkeley

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Contents

Figures

Tables

Introduction

In Japan . . . zaibatsu *and other affiliations link industrial, commercial, and financial firms in a thick and complex skein of relations matched in no other industrial country.*

Caves and Uekusa, 1976:59

Networks and the Japanese "Miracle"

Japan is by all accounts the advanced capitalist society whose market transactions have been most intertwined or embedded in social relations, as Caves and Uekusa suggest in the quote above. The most conspicuous form of network organization in the Japanese economy is keiretsu, a term referring to clusters of interlinked firms that, in the late 1980s, sounded exotic and intimidating given the competitive might of Japanese business at the time, but in the early 2000s smacks of third world crony capitalism, the rigidities of an overly managed economy, and anachronism.

Thus, how Japan's forms of business organization are seen fluctuates with the country's economic fortunes. From the 1950s until the early 1970s, when Japan was growing rapidly but on most development criteria still lagged behind Europe and the United States, a dominant view was that Japan's distinctive economic institutions were cultural anomalies, and the nation's economic advancement was proceeding *in spite*, not because, of them.[1] In the 1980s, with Japan emerging as the equal, if not the superior, of the West in an array of business and technological endeavors, while retaining, even leveraging, its exotic network forms, the flavor of the commentary changed. Japan's peculiar patterns of industrial organization were then claimed to have evolved in ways that enabled the performance with considerable efficiency of the critical functions of a modern market

[1] See, e.g., Abegglen (1958).

economy. Its complex network structures looked to be evolutionary advances on Anglo-American style labor, capital, and product markets. Keiretsu ties, main bank monitoring, stable shareholders, and active industrial policy were no longer the residues of Japanese feudalism but were recast as worldwide best practice.

New bodies of economic and management theory argued the merits of Japanese-style corporate governance arrangements, not only in Japan, but in the West as well.[2] Scholars and policy makers concerned with the inability of American shareholders to obtain complete information from and exercise real control over the salaried managers who ran corporations looked to the Japanese system of main bank ties and concentrated and stable shareholding for lessons in the design of corporate monitoring and disciplining systems. Managers, consultants, and policy makers concerned with the quality declines and falling competitiveness of U.S. manufacturing saw a model to emulate in the Japanese vertical keiretsu network, in which a major assembler maintained close, trusting, and reciprocal relations with a relatively small cadre of dedicated suppliers and subcontractors.

Japan in the 2000s: The Collapse of Crony Capitalism?

What a difference a decade can make. The perception is now strong that, battered by global competition, technological change, and (in rapid succession) boom and recession, Japan's network forms of organization – long seen as central to the economy if not the Japanese way of life – are unraveling, leaving Japanese business more market oriented, transparent, arm's length, and geared to the short term. With the bursting of the asset-price bubble in 1991 and the country's plunge into ten years (and counting) of recession and stagnation, the scholars, journalists, and practitioners who had bought the paradigm of Japan as vanguard economy have struggled mightily to find an explanation for what was going on. The easy one, advanced enthusiastically – even jingoistically at times – by hard partisans for the U.S. brand of capitalism, was simply that Japan's chickens had come home to roost. In the Japanese economic crisis – and that of Asia more generally – the long-overdue comeuppance of network or crony capitalism was at hand. Broadly shared again is the sense that Japan succeeded in the past only because it overcame the inherent limitations of its network institutions. Their continued persistence, however, explains the downward spiral of the economy in the 1990s. Critics see the structure

[2] Aoki (1988); Dore (1983); Ouchi (1986); Lazear (1979); Sheard (1989a); Womack, Jones, and Roos (1990).

and functioning of Japan's network economy behind an assortment of contemporary ills – from complacency and uncompetitiveness rooted in inbred trade and investment practices to the protection of the corporate unfit and the spread of *moral hazard* due to widespread subsidies and easy bailouts.[3]

Thus, in the global competition of economic paradigms, it appeared by the end of the twentieth century that the American way – with its distinctive mix of large corporations, efficient markets, legal contracting, "tooth and claw" competition, and weak employment relationships – had triumphed.[4] Despite their short-lived posturing as serious alternatives, the continental European and East Asian models were exposed as inefficient and unsustainable, and the United States was once again the global icon of market rationality. The seeming virtues of patient capital, long-termism, the subordination of profit seeking to growth and scale, relationship investing, and stakeholder capitalism had proved hollow and fleeting. Only a decade or so ago such practices were extolled by American academic luminaries such as Lester Thurow, whose book *Head to Head* argued the superiority of German and Japanese "communitarian capitalism."[5] Now, cozy and reciprocal relationships among stable business partners are judged to misallocate capital and distort corporate goals and strategies, all to the deep and lasting detriment of the economy as a whole.

After more than thirty years of relative stability, much evidence backs the conclusion that, however halting and uneven the process, Japan is shedding its "networkness." Under pressure to raise liquidity and dispose of underperforming assets, banks are writing off problem loans and selling "stable" shares, thereby canceling implicit insurance contracts with long-term clients. Manufacturers have responded to pressure from international trading partners to purchase more from foreign vendors. Pressed to cut costs in high-wage Japan, they have also reduced their commitments to domestic suppliers by shifting production offshore, sourcing online, and entering into pacts with one another to design and produce components.[6] Rising concerns over health, working hours, and family life

[3] On the role of the Japanese main bank and *convoy* systems in breeding moral hazard, see, for example, Spiegel (2000).

[4] As a *Wall Street Journal* article documented (Murray, 2001), the popular notion that big firms had gone the way of the dinosaur in the new American economy was largely myth. "By 1999, the average annual revenue of the 50 largest public companies in the U.S., about $50.8 billion, was 70% higher than it had been just 15 years earlier, even taking inflation into account. More than 50 public companies currently employ more than 100,000 workers; in the mid-1980s, only 18 did." For a scholarly treatment of small firms in the United States that reaches similar conclusions, see Harrison (1994). On small firms in Japan, see Friedman (1988) and Whittaker (1997).

[5] Thurow (1993).

[6] Ahmadjian and Lincoln (2001).

(e.g., Japan's low fertility rate) have further eroded business networks as managers and officials spend less time in boozy evening social gatherings (*tsukiai*) cultivating interpersonal ties (*jinmyaku*).

Do Japan's network structures deserve the blame now heaped upon them for the country's chronic country travails? Is their wholesale elimination the harsh medicine the economy needs in order to stage a return to steady growth? Many observers who concede that the keiretsu and other network structures played a useful role in the catch-up, high-growth phase of Japanese economic development (1950–73) now feel those forms have long outlived their usefulness. Japan is no longer playing catch-up – it needs to lead, not follow – and the global rules of economic play have changed in fundamental ways.

However, while Japan has stumbled badly, a case can be made that much of the cause lies with the peculiar mix of conditions associated with the late 1980s bubble, a time when Japanese business, caught up in a wave of "irrational exuberance" (to use Alan Greenspan's colorful phrase), embraced what looked more like the style and values of American business than those the world had come to associate with Japan. As one scholar noted:[7]

> sustained by the liberalization of finance, Japanese corporations began to shift away from their real businesses to financial speculation. When the world praised Japanese corporations for their long-term thinking in business strategy in the 1980's, Japanese corporations had begun to turn to short-term profits earned at a rapid rate.

In the bubble years, leading industrial corporations such as Toyota, Sony, and Honda, much admired for their manufacturing capabilities, were making 40–60 percent of their pretax profits from financial machinations or *zaitech*. In 1990, a prominent Tokyo consultant told us, it was very difficult to get a Japanese bank to invest in a manufacturing venture that might take years to produce a return when that same money put into real estate would yield a superior gain in a matter of weeks. An array of forces in the late eighties – the growth of equity financing by large firms, the shift of bank finance to small and medium sized firms, excess household savings, the government's expansionary fiscal and monetary policy, the sharp escalation of the yen a few years before, and widespread construction industry subsidies, not to mention a certain national chutzpah borne of global manufacturing success – conspired to drive stock and real estate prices to astronomical levels. The explosion in wealth also

[7] Gao (2001:169).

spawned vast overinvestment in production capacity, setting the stage for steep cutbacks in the wake of the bubble's 1991 collapse.

Moreover, while we will show that the major keiretsu groupings were weakened by the bubble, there is no denying that the speculative fever of the times was both the offspring of and exacerbated by the system of sticky business ties. Cross-shareholdings within the "big-six" horizontal groups (Mitsubishi, Sumitomo, Mitsui, Dai-Ichi Kangyo (DKB), Fuyo, and Sanwa) enabled companies to issue huge volumes of new shares and find ready buyers yet not risk takeover. More important, a far-flung corporate safety net, woven largely of reciprocated keiretsu commitments but also of an array of government supports, spawned an epidemic of moral hazard – the taking of excessive risks on the presumption that someone else would bear the downside. Firms threw money at risky ventures in full confidence that if the bottom did fall out, a main bank or keiretsu bailout would surely be forthcoming.

Finally, in the superheated business climate and brimming overconfidence of the times, the monitoring mechanisms that had in the past afforded some protection against moral hazard broke down. The growth of equity financing in the 1980s undercut the main bank relationship. Indeed, keiretsu relations, instead of monitoring and constraining risky and opportunistic behavior, often fueled it. Large banks and blue-chip corporations used affiliated firms as fronts for dubious real estate and stock deals.[8] Other players, quick to note the heavy hitters lined up to back such ventures, assumed that an investment in trading company Itoman (for example) was a de facto bet on its patron, Sumitomo Bank.[9] While Western policy makers and economic critics such as Richard Katz and Taggart Murphy see the economic gloom of the 1990s as a case of chickens coming home to roost – the accumulated failings of the network economy overwhelming Japan's manufacturing strengths – many in Japan hold to a very different view. In the heated internal debates over what went wrong, one prominent school of thought has it that Japan's travails in the 1990s are the bubble's doing pure and simple. Perhaps the bubble was, as the Western critics suggest, the inevitable outcome of the

[8] An amusing anecdote along these lines is the story of the Osaka restaurateur and stock speculator Nui Onoue, chronicled in Kerr (2001). Onoue possessed a ceramic toad, which, she claimed and many bankers and stockbrokers believed, gave her the powers to divine the movements of the stock market. "At its peak in 1990," writes Kerr, "the toad controlled more than $10 billion in financial instruments, making its owner the world's largest individual stock investor."

[9] Itoman was an Osaka trading company that became involved in a number of extravagant but highly shady art and property deals. Itoman received some ¥600 billion in loans from Sumitomo Bank for this purpose. Its collapse and the exposure of the underworld-linked ventures severely sullied Sumitomo's reputation, cost its chairman his job, and later contributed to the resignation of Ichiro Isoda, the bank's prominent president.

system's built-in flaws – that sooner or later it was *bound* to happen – but that is not an easy thing to prove. Japan, after all, had navigated quite successfully around a host of macroeconomic shocks and hazards in the past. Many of the economy's network trappings – large insider boards, keiretsu obligations, main bank ties, tight-knit trade associations, guidance by regulators – seemed to function well in the days when Japanese business was all about investing for the long term, honoring obligations to patient stakeholders, making quality products, and growing the firm. But they generated calamitous results when Japanese business abruptly switched its energies to financial wheeling and dealing. Had the bubble never happened, the Japanese economy, its deep-set network institutions included, might still be going strong – or at least stronger than it has – and the country would have been spared the trauma of the "lost decade." In this reasoning, the bubble was utterly destructive of Japanese economic vitality because it was such a radical departure from the fundamentals of the post-war business system.

In any case, the negative fallout from the bubble has been extraordinarily hard to expunge. Some twelve years after the Nikkei Index lost half its value in the space of two years (from 38,000 in 1990 to 15,000 in 1992), the index as of this writing, is below 8,000. Land prices in six major metropolitan areas are 30 percent of what they were in 1990. Japan remains in trouble, much of it the direct or indirect hangover of the unsustainable business practices of the bubble era.

A principal finding of the research we report in this book is that, as far as the keiretsu are concerned, the bubble *was* to some degree anomalous – during it, ties frayed markedly but with its passing some facets of the network regime were restored. Others, however, seemed to be gone for good. Cross-shareholding – the signature tie from which the keiretsu were woven – lost much of its macro-network character. The banks' positions in the network, already weakened by financial deregulation and disintermediation, deteriorated further in the bubble and did not recover in its wake. The strongest keiretsu groupings – those descended from the pre-war zaibatsu – regained much of the cohesion they surrendered in the bubble, but the weaker clusters – the bank-centered groups – did not.

Then in the mid-1990s, under the pressure of continued economic decline, a further "regime shift," to use Pemple's apt characterization, took place.[10] The institutional framework for Japanese network capitalism was assaulted from every side. Regulatory adjustments eroded the foundation for keiretsu. Revisions to bankruptcy law made legal filing easier and raised the profile of the courts in business restructurings, thus sidelining

[10] Pempel (1998).

banks and keiretsu partners. The lifting of the Occupation-era ban on holding companies returned to managers the device for coordinating a diverse set of businesses on which the pre-war zaibatsu had been built and the absence of which in the post-war era brought the keiretsu into being. New corporate governance guidelines shrank boards and separated director and executive roles in ways that limited keiretsu involvement in the decision making of member firms. Accounting rule changes forced companies to disclose how their finances meshed with those of their affiliates. Next came a wave of consolidations and alliances, first of banks and then of their industrial clients. New exchanges such as NASDAQ Japan and the Mothers section of the Tokyo Stock Exchange were established to spur the founding and growth of new business, and, indeed, a number of new firms grew to prominence on the strength of innovative business models (e.g., Internet sales). New government entities – the Financial Services Agency, Financial Reconstruction Commission, and, most recently, the Industrial Revitalization Corporation – exposed the shadier of keiretsu practices and preempted the role of the bank-keiretsu convoys in industrial adjustment and corporate rehabilitation.

In sum, the institutional rug was being pulled out from under the Japanese network economy. As we suggest in Chapter 6, no one such change taken on its own merits necessarily had great import, but in combination they reshaped the Japanese business landscape in ways that made the received relational configurations much harder to sustain. The old networks are by no means entirely withered away. Much of the evidence we review in these chapters shows them persisting in various forms and sectors, even as their legitimacy fades and the legal and normative pillars supporting them topple. They still have their advocates in business, government, and the press. Even without them, the roots of network capitalism run so deep in Japan that they are not easily dislodged. Sometimes they resurface in new and unexpected ways, such as the move in 2003 (to loud condemnation by the Western business press) by Toyota to rescue failing trading company Tomen. Some recent upticks in the economy's performance, coupled with the dramatic collapse of the U.S. Internet economy bubble, have evoked in Japan a surge of support for traditional ways. More than a few Japanese are unsold on the virtues of the American "market-individualist" model, as Ronald Dore (1973) called it, and quite a few took satisfaction in its humiliating fall from grace in the corporate scandals of 2001–02. While acceptance of the need for market-oriented reform remains broad, many Japanese, like many Europeans, still see value in the network economy and wish to preserve some measure of it.[11]

[11] Dore (2000); Lincoln and Nakata (1997); Orru, Biggart, and Hamilton (1997).

The Agenda: A Structural Analysis of Japan's Network Economy

Our work has been a long time in the making, and over the years we were interviewing, coding, and analyzing data and writing, Japan was not sitting still. Any research addressed to recent events faces similar problems, but the study of the Japanese political economy of the 1990s is particularly challenging in this regard. From the 1960s until the late 1980s, the foundation of the Japanese business system evolved in various ways – for example, in the shift on the part of large corporations from bank to equity finance in the 1980s – but the system's core stayed largely the same. As the economy expanded, Japan became rich, powerful, and a global business and technology leader, but the network character of its political economy held firm. A tight hierarchical social order within firms and bureaus and a thick tapestry of relations among them were its distinguishing features.

In Chapter 6 we devote considerable space to these and other changes, but the core of our quantitative analysis falls within the "old" network paradigm of Japan. That stability is evident in the persistence of the large financials and industrials at the economy's core. Neither merger/acquisition activity nor entry by new firms appreciably altered the rank ordering of the largest Japanese companies over the thirty-year period we observe. Without such stability, much of our longitudinal analysis, which follows the largest 259 (as of 1980) financials, industrials, and trading companies, could not have been done. By the same token, the changes of the late 1990s and early 2000s preclude taking our quantitative inquiry right up to the present.

Our subject is business networks in Japan – chiefly the horizontally and vertically organized groups or keiretsu. We study how they arose and were structured, how they evolved from the 1960s to the 1990s, and how they functioned – particularly in terms of the support of weak firms at the expense of strong ones. Keiretsu is a fascinating organizational form, for, unlike the centralized business groups of Korea, India, and elsewhere in the global economy, the keiretsu are true *network organizations*. In Lockwood's (1968:503) words, they are "webs with no spider" – no holding company or home office or family of owners sits at the top and pulls the strings.[12] They do have leaders – the banks and trading companies of the horizontal groups and the parent manufacturers in the vertical keiretsu – but the minority equity stakes and periodic personnel dispatches that link firms together are not sufficient to give any one corporate actor

[12] On the question of what organizational forms are encompassed by the term *business group*, see Granovetter (2003).

group-wide control. The cohesion and definition of the groups derive from webs of relatively thin and weak ties.

As the keiretsu are bona fide networks, they are apt candidates for a study making use of the methods and perspectives of sociological network or structural analysis. Structural analysis is a powerful paradigm, comprising an array of tools for analyzing social ties, whether of individuals or groups. It also boasts a set of rich relational concepts – such as density, connectivity, multiplexity, and reciprocity – and propositions relating them to social and economic action. The field of economics has developed its own conceptual and methodological apparatus for studying business and organizational forms. These – principal–agent theory and transaction cost economics in particular – have been quite influential in the social sciences. They differ from the sociological perspectives in that (1) they are more mechanistic in their assumptions of an efficiency imperative and hyperrational self-interested actors, and (2) in their focus on the dyad – the transacting pair – as unit of analysis to the general neglect of the broader network in which that pair is likely to be embedded. As Oliver Williamson put it: "Transaction cost economics is preoccupied with dyadic relations, so that network relations are given short shrift."[13] However, at many junctures the lessons offered by the economics models are either similar to or complement the sociological views. The reader will see in the chapters to follow that, while we favor a sociological story, we are eclectic in how we draw upon theory in our attempts to understand the evolving structure and functioning of Japan's network economy.

[13] Williamson (1994).