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Gundamnomics: Transforming Corporate Japan for the Challenges of Global Capitalism

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(summary)

It is no surprise that in August 2007, Michael Bay's *Transformers* debuted in Japan with an opening weekend of ¥631.3 million, the number one at the Japanese box office. The *Transformers* franchise, from which Bay's film was adapted, began with a 1980s animated television series that was not only based on designs by Japanese toy manufacturer Takara and produced by Toei Animation, but was also inspired by the classic Japanese animation genre of giant transforming robots that includes *Voltron*, *Super Dimension Fortress Macross*, and *Mobile Suit Gundam*. If this genre was a metaphor for the successful postwar transformation of the Japanese economy into a global powerhouse, *Transformers* is not merely a part of Japanese cultural imagination, but may well be the history of corporate Japan – and perhaps also its future.

With the passing of the 'lost decade', it is time for corporate Japan to undertake a new strategic transformation to meet the dynamic challenges of global capitalism. In this essay, I argue that the collapse of the asset-price bubble and subsequent banking crisis created fundamental systemic changes to Japan's political economy and institutions, and heightened its sensitivity to international capital markets and global economic forces. These challenges will require Japanese companies to achieve an efficient allocation of physical, financial, and human capital by adjusting their human resource management policies to leverage on foreign and female talent, adopting a more meritocratic and flexible corporate culture, and changing their approach to corporate governance.

(full text)

Gundamnomics: Transforming Corporate Japan for the Challenges of Global Capitalism

Introduction

It is no surprise that in August 2007, Michael Bay's *Transformers* debuted in Japan with an opening weekend of ¥631.3 million, the number one at the Japanese box office.[1] The *Transformers* franchise, from which Bay's film was adapted, began with a 1980s animated television series that was not only based on designs by Japanese toy manufacturer Takara and produced by Toei Animation, but was also inspired by the classic Japanese animation genre of giant transforming robots that includes *Voltron*, *Super Dimension Fortress Macross*, and *Mobile Suit Gundam*.[2] If this genre was a metaphor[3] for the successful postwar transformation of the Japanese economy into a global powerhouse, Transformers is not merely a part of Japanese cultural imagination, but may well be the history of corporate Japan – and perhaps also its future.

With the passing of the 'lost decade', it is time for corporate Japan to undertake a new strategic transformation to meet the dynamic challenges of global capitalism. In this essay, I argue that the collapse of the asset-price bubble and subsequent banking crisis created fundamental systemic changes to Japan's political economy and institutions, and heightened its sensitivity to international capital markets and global economic forces. These challenges will require Japanese companies to achieve an efficient allocation of physical, financial, and human capital by adjusting their human resource management policies to leverage on foreign and female talent, adopting a more meritocratic and flexible corporate culture, and changing their approach to corporate governance.

Postwar transformation and crisis

Japan's rapid postwar economic recovery is often described as a 'miracle', yet it was not the result of divine but human agency: Japan's leaders pursued an aggressive industrial policy aimed at export-led growth, which regulated interest rates to keep borrowing costs low and protected infant industries through subsidies and tariffs. This transformed the Japanese economy into an industrial architecture that centered on the *keiretsu* networks of preferential trade relations, relationship lending, and reciprocal cross-shareholdings within groups of manufacturing firms and financial institutions,

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1 Schilling (2007)
2 Robson (2007)
3 As discussed in, among others, Patten (2004) p. 286.

some of which were reconstituted descendants of the prewar *zaibatsu*.[4]

This *keiretsu* system was integral to the catch-up phase of Japan's economic development, because it provided relative insulation from the risks of competition in the global economy. First, hierarchical and preferential trade relations between diversified members, combined with trade protection, provided firms with minimum sales volumes and stable earnings. Second, in-group relationship lending, combined with regulated interest rates, provided firms with leverage via cheap long-term debt financing and 'patient capital'. Third, reciprocal cross-shareholdings provided insurance from hostile takeovers. All of these factors allowed firms to focus on their long-term goals of scaling up and gaining market share.[5]

Unfortunately, this insulation also came with costs that proved unsustainable. First, by insulating firms from fundamental profitability and efficiency concerns through preferential trade and relationship lending, the *keiretsu* system distorted incentives and enabled the misallocation of capital and overinvestment in production capacity. Second, stability was also rigidity, which not only constrained firm strategies, but promoted complacency and moral hazard after years of easy bailouts from *keiretsu* networks and the government. This encouraged the excessively risky speculation that fueled the asset-price bubble.[6] Its subsequent collapse incurred huge losses for the banks, resulting in the bankruptcy of two large banks in 1997.[7] Even the cut in interest rates to zero percent could not stop the deflationary spiral into recession. The main banks could no longer support zombie businesses and non-performing loans that were the result of their relationship lending and reciprocal cross-shareholding, and the *keiretsu* system began to unravel as credit dried up while the banks restructured and merged.[8]

The banking crisis resulted in systemic changes to Japan's political economy. Financial reforms that established the Financial Services Agency required stricter disclosure and greater transparency of corporate accounts on consolidated balance sheets. New bankruptcy legislation through the Civil Rehabilitation law (2000), and the revised Corporate Reorganization law (2003) and Liquidation law (2004) facilitated reorganization and restructuring. Revisions of the Commercial Code enabling stock buybacks facilitated mergers and acquisitions, and the Corporation law (2006)

[4] Schaede (2006), p. 3.
[5] Ibid, p. 3-5.
[6] Lincoln and Gerlach (2004), p. 5-6.
[7] Schaede (2006), p. 7.
[8] Ibid, p. 13.

increased flexibility for management and reformed the corporate governance system.[9]

No longer able to depend on relationship lending from main banks and *keiretsu* partners due to financial sector regulations, today's firms must raise funds from capital markets, where the dominant shareholders are foreign and domestic institutional investors and trust banks.[10] However, without the protection of reciprocal cross-shareholdings, and under the revised commercial laws, firms are now vulnerable to takeovers and acquisitions should they show financial weakness. Corporate governance reform also means that the interests of shareholders come first, and shareholder activism by institutional investors like CalPERS and the Japan Pension Fund Association is likely to increase.[11] All of the above mean that profitability is now the top priority of corporate Japan, as shareholders are chiefly concerned with share prices and dividends from profits.

As profit is the excess of revenue over cost, its maximization is a matter of optimizing production across the marginal costs, benefits, and rates of substitution. In other words, profit maximization requires firms to achieve an efficient allocation of resources. The new transformation of corporate Japan is therefore to achieve this efficient allocation of its physical, financial, and human capital.

Maximizing human capital

Of the three forms of capital mentioned above, human capital is the most important to Japan's advanced stage of economic development, where technological innovation and creativity are the key factors to success. Human capital is also one of Japan's core advantages, as its population has one of the highest levels of tertiary education in the world. However, that advantage may soon be eroded due to low fertility rates and the near-retirement age of the postwar baby-boomer generation, exacerbating a labor shortage and pushing wages further upward in a business environment that is already relatively expensive.

With a birth rate of 1.29 in 2004, Japan's population is projected to have peaked in 2006 and then steadily decline. Japanese men and women are staying single longer, and have fewer children if they marry at all. The government has responded to the population crisis with pro-natal policies, but these have so far been ineffective in raising fertility to any meaningful degree. Importing labor by increasing immigration is a politically sensitive issue, and as a Goldman Sachs Global Strategy Report finds,

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9 Ibid, p. 8-10.
10 Ibid, p. 26.
11 See Jacoby (2007) for a discussion of the role of CalPERS in reforming the corporate governance system.

the scale of immigration required to maintain the present workforce population would require a sevenfold increase in the annual intake of immigrants.[12]

There are two other strategies to address the population crisis: 1) increase the stock of human capital through higher labor force participation, and 2) increase the productivity and efficiency of existing human capital. Both strategies will be required to maximize Japan's human capital, and Japanese firms must implement them successfully in order to compete effectively for top talent.

Increasing labor force participation

There are two approaches to increasing labor force participation in Japan. First, by raising the retirement age, and second, by boosting minority participation i.e. foreigners and women.

Japan's life expectancy is one of the highest in the world (85 for women and 78 for men), yet with its aging population, the average retirement age is 60, which places even greater pressures on pensions and individual retirement savings. Raising the retirement age to 70 could not only alleviate these social pressures, but could also slow the decline in the labor force while other human resource management policies are pursued. However, this is not a solution, as firms will only retain workers who contribute to overall profitability, and despite having greater experience, elderly workers are less likely to possess the innovative and creative skills required.

As one Harvard Business Review article[13] puts it, firms seeking talent should tap on the "leadership in [their] midst… minority executives" whose community leadership and responsibilities are often undervalued by human resource executives. These executives not only develop valuable skills off-the-job, but also possess social capital within their communities that can be a strategic asset. In the Japanese context, these minority executives are foreign employees, whether those hired locally at regional branches in Asia, or serving at the headquarters in Japan. One study finds that while US and German multinationals rely heavily on local executives to manage overseas affiliates and branches, more than 70% of Japanese multinationals employ only Japanese expatriates.[14] Japanese firms going global should tap on the local knowledge, experience and community leadership of local staff at all levels of management, who are often more cost-effective than expatriates, and even consider them for roles within Japan. Otherwise, talented employees will be inefficiently underutilized, and firms will lose out on a valuable resource.

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[12] Goldman Sachs (2005), p. 3-4.
[13] Hewlett et al (2005), p. 76.
[14] See Belderbos and Heijltjes (2005), p. 342 for a discussion of why this is the case.

Yet there is an even greater segment of the labor pool that is underutilized by Japanese firms: women. Japan's female labor participation rate, although rising, remains lower than other developed countries, despite comparable levels of higher education.[15] One should note that a recent Harvard Business Review article[16] considers US female participation rates in corporate leadership suboptimal, which implies that Japanese rates are likely even worse. This is highly inefficient from a national perspective, and presents Japanese firms an opportunity to leverage on undervalued talent. Unfortunately, Japanese corporate culture has been the primary cause of this phenomenon, with many firms retaining discriminatory practices like gender-based dual-track career systems and inadequately resolving sexual harassment offences.[17]

Although years of equal employment opportunity legislation have not made a meaningful difference to female labor participation rates, this will change as soon as Japanese firms recognize that companies who are able to retain top female talent will have a significant competitive advantage in the labor market. To do so, Japanese firms must not only cease discriminatory practices, but actively create "off-ramps and on-ramps", as another Harvard Business Review article[18] argues. These offer female employees career tracks that balance career development with family life, such as reduced-hour or flexible work arrangements (in exchange for lower earnings), which will allow women to have children while retaining their skills development, so that they can return to full-time employment smoothly.

This strategy is not limited solely to female employees. The most effective Japanese firms will be proactive in identifying and catering to the needs of their top talent, regardless of gender, because they will attract and retain the most creative and innovative employees. Japanese companies lose valuable talent if their employees are overworked to the point of burnout or death (*karoshi*), or if employees must choose between irregular part-time employment, and sacrificing social and family life. This will require a general transformation of Japanese corporate culture and human resource management practices.

Improving human capital productivity and efficiency

One measure of the productivity of an economy is Total Factor Productivity (TFP), which is the function between national income, and capital and labor. Yet a recent Research Institute of Economy, Trade and Industry (RIETI) study finds that Japan's

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15 Goldman Sachs (2005), p. 7.
16 Eagly and Carli (2007)
17 See Weathers (2005-6) for a comprehensive discussion of discriminatory practices.
18 Hewlett and Luce (2005), p. 50-52.

TFP growth has not only slowed down, but is also relatively low in services and other non-manufacturing sectors, which requires "better resource allocation".[19] Another recent report by the Japan Center for Economic Research that focuses specifically on labor productivity finds that it is "only 61 percent of the United States'".[20] Both of these findings suggest that human capital is not being efficiently allocated by firms. Either employees are not the most qualified candidates, or they are not working at their full potential.

This inefficiency may lie in traditional Japanese corporate culture and human resource management practices, which have included total job security, lifetime employment, seniority-based wages and delayed promotion. Although these practices build loyalty to the firm and encourage the accumulation of firm-specific organizational knowledge and social capital, they are not primarily based on performance. In some cases, they can even create incentives against performing well: some managers might not pursue a profitable but risky venture for fear of jeopardizing their tenure, or not speak against a bad decision for fear of damaging long-term relationships. The lack of dismissal also forces firms to retain unproductive and inefficient workers, and reduces overall labor mobility. Although some of these practices appear to be in decline, some studies find that they continue in many companies.[21]

In a meritocratic and flexible system of recruitment and promotion, employees will have the incentives to compete on the value they add to the firm's profitability, and only the most effective employees will rise to top management, while obsolete jobs and inefficient workers will be replaced through a Schumpeterian process of 'creative destruction'.[22] One RIETI study[23] finds that the adoption of meritocratic and flexible human resource management practices correlates with non-traditional and foreign ownership, while other studies find that foreign ownership correlates with higher TFP, earnings, growth and return on capital.[24] It follows that in order to pursue an efficient allocation of capital, human or financial, Japanese firms must also change their approach to corporate governance.

Optimizing financial capital

Despite the extensive corporate governance reforms and legislation, there remains substantial opposition in Japan, led by the Japan Business Federation (*Nippon Keidanren*), against shareholder primacy, foreign ownership, and external supervision

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[19] Fukao (2007)
[20] Suzuki (2007)
[21] Masahiro and Takeo (2004)
[22] See Ariga (2006) for a study of these processes at a Japanese manufacturing firm.
[23] Masahiro and Takeo (2004)
[24] See Fukao et al (2005) and Kimura and Kiyota (2007)

of management through independent boards and auditors. When William Crist, the president of CalPERS visited Japan in 1993, his visit was even likened to Admiral Perry's black ships.[25]

Japanese firms must cater to shareholder interests in order to obtain financing from investors. In the new institutional and legal environment, the interests of institutional investors are of prime importance, as they are now the dominant shareholders. Unlike the main banks who offered reciprocal cross-shareholdings and relationship lending terms, institutional investors will not support a long-term 'patient capital' approach of market share expansion, high diversification, or risky technological bets. Many of these pension trusts and retail funds compete on return on investment, and are more interested in profitability than growth. As these institutional investors take on greater shareholder activism roles, firms who do not cater to their needs will be at a disadvantage, and also become vulnerable to takeovers.[26] Japanese firms will find that voluntarily adopting external supervision through independent boards and advisors is much better than risking a hostile takeover by a turnaround fund that has little concern for the welfare of employees.

This does not mean that Japanese firms should be forced into adopting corporate governance reforms. After the Company with Committees legislation was made optional, only 107 companies voluntarily adopted the system by 2005, and even where it was adopted, it was often not implemented fully.[27] Without buy-in, true reforms are likely to be subverted by special interests.

The new transformation

True change can only come from within, and corporate Japan's transformation is no exception. The postwar transformation into the *keiretsu* system of insulation and protection from global competition is no longer sustainable. The real value proposition of the *keiretsu* are the benefits that "make members *more competitive* and profitable" (emphasis mine), such as "information sharing, brand name recognition", "advanced financial support", "pooled labor", "specialized knowledge in new technologies" and "joint subsidiaries."[28] Yet Japanese firms can only leverage on these benefits if they embrace the challenges of global competitiveness. Like the giant *Gundam* robots of Japanese animation, corporate Japan will successfully transform itself to meet the challenges ahead. It has done so before, and it must do so again.

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[25] Jacoby (2007), p. 8.
[26] Schaede (2006), p. 29.
[27] Buchanan (2007), p. 29-30.
[28] Schaede (2006), p. 37.

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